THE FUNDAMENTAL PRINCIPLES OF TAXATION

IN THE LIGHT OF MODERN DEVELOPMENTS



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THE FUNDAMENTAL PRINCIPLES OF TAXATION

IN THE LIGHT OF MODERN DEVELOPMENTS

BY

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TO

MY WIFE

PREFACE TO NEW EDITION

THESE lectures were never intended to be a text-book on Taxation in which could be found a detailed description of particular methods and schemes in existence, and still less an historical survey of their development. They were designed to supplement such ordinary comprehensive and straightforward studies of public finance, by providing tests from three specially denoted angles, and furnishing illustrations of those points of view drawn from different fields of practical taxation. With the course of time some of these illustrations are out of date, or superseded.

I found it impossible to rewrite this book and still preserve its original lecture form. It must remain always as a picture of thought and experience at a particular stage in our history. But that does not mean that it need have only an historical significance, and I believe it is still important to emphasise the three approaches to the taxation problem. I have accordingly brought some of its statements to date by correcting footnotes, and introduced direct into the text a good deal of new matter, illustrations from more recent events, and references to later problems, clearly distinguished by square brackets as being so introduced, for the guidance of the student.

My main conclusions on taxation have been contributed in detail in the "Colwyn" Committee's Report, and this volume is only intended to be an introduction to the subject along three broad approaches.

J. C. S.

June 1936.

PREFACE TO ORIGINAL EDITION

These Lectures, delivered to public audiences at the end of 1919, under the Newmarch foundation of University College, London, are now published in book form in response to numerous requests from those who heard them and from others in different parts of the world.

I have thought that, on the whole, it was best to leave them practically in the form in which they were given, and without correction, for modifications in practice that have since taken place, beyond brief footnotes.

For the convenience of students who wish to pursue and study any particular points, a number of references have been given.

I would remind readers that it was no part of my design to make a complete appraisal of any tax, and that critical references to particular aspects of a particular tax for the purpose of illustrating general principle should not be taken to imply a balance of approval or disapproval of that tax taken *as a whole.* Such views may be gathered elsewhere.

J. C. S.

September 1920.

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NOTE ON ABBREVIATIONS USED IN THE FOOTNOTES

Select Committee on the Income Tax . . .	1851–52
Joint Committee on the Income Tax . . .	1863
Departmental Committee on the Income Tax . .	1905
Select Committee on the Income Tax . . .	1906
Royal Commission on the Income Tax . . .	1920

The Reports and Evidence of the above are referred to briefly by the date, *e.g.* "1906 Comm."

Report of the Committee on National Debt and Taxation. "Colwyn Committee," 1927.

E.J. = *Economic Journal.* Writings by the author are distinguished thus : (S.).

Readjustments = Readjustments in Taxation. *The Annals of the American Academy of Political and Social Science,* March 1915, No. 147.

Foreign Income Taxes, 1905 and *Foreign Income Taxes,* 1913 = Bluebook on Graduated Income Taxes in Foreign States, 1905 and 1913.

Dowell = History of Taxation in England, by Stephen Dowell.

CHAPTER I

THE GENERAL TREND OF RECENT DEVELOPMENTS AND THE NEED FOR RESTATEMENT OF PRINCIPLES

1. WILLIAM NEWMARCH, in whose name these lectures are given, was first and foremost a great statistician, but he was also a realistic economist, a recognised authority on questions relating to taxation, and an exponent of the principles accepted in his day. Many of the distinguished men who have spoken from this platform have dealt with the practical aspects of economics, and I am making no bold departure in selecting as my subject for these lectures "The Fundamental Principles of Taxation in the Light of Modern Developments."

Features hitherto Latent are revealed by the Present Financial Strain

The defects in a photographic negative are often negligible, or, at any rate, tolerable, until we enlarge the picture, when they become clear to all. Gulliver found the complexions of the beauties of Brobdingnag not quite to his liking, and the difference between perfection and imperfection is rarely absolute, but a question of degree. Taxation is

now rapidly developing from a merely unpleasant incident into a dominating feature of daily life, and those features which hitherto have been of little interest, because they have been too small to matter, now become of great importance; the blemishes which were insignificant may now be intolerable simply because in the magnitude of the burden they have become sufficiently magnified or intensified to be within the range of ordinary human feeling. There would probably have never been any society "for the abolition of double taxation within the Empire" if income taxes had remained in the region of 8d. in the £. First, new problems arise merely through the increasing complexity of modern economic life. Secondly, the growing field of State activity and the enlarged communal consciousness necessitate demands for increased individual contributions towards common spending. These causes alone would suffice to bring about a re-examination of principles. But when there is added the financial legacy of a gigantic war, the most supine taxpayer begins to be interested and critical, and the number of potential or self-constituted Chancellors cannot well be *less* than the total membership of our West End Clubs, and is limited only by the extent of the adult population! It is not merely that the existing structure of taxation methods is stretched to its utmost limits and shows every crack and every patch; but the search for new methods and untapped resources also leads men to ask for statements of the principles upon which taxation can properly be based.

2. *Adam Smith's Canons: an Attempt at Synthesis*

I suppose that when the principles of taxation are referred to, the majority of people think instantly of the famous four canons of Adam Smith, summarised under the headings: Equality or Ability, Certainty, Convenience, and Economy. These have indeed performed noble service in economic thought and teaching for over a hundred years. It has often been said that the most elaborate modern teaching is really found in essence in Adam Smith's plain phrases—they were indeed progenitors of thought. But it can hardly be affirmed that we can find enshrined in those four sentences the whole duty of man and the State amid our modern perplexities. To get to America, "turn to the west and keep straight on," might have been excellent advice from Columbus, but is hardly adequate as a direction to the *Mauretania* seeking New York.

Attempts have been made from time to time to get the highest common factor of the principles of taxation, and one writer has proclaimed that the grand principle of all is "Economy." [1] By giving the latter a sufficiently wide and rich connotation he has made it comprise all that is vital in the other principles. For it is not difficult to show that violations of the various canons are either "uneconomical" or are working against true "economic" lines. It is, however, not so much verbal synthesis that we need in these days as a careful and extended analysis, and rather than

[1] R. Jones, *The Nature and First Principle of Taxation.*

reduce the number of principles we have to subdivide and elaborate them, and to increase their number in application to the actual conditions of to-day.[1]

3. *The Maxims repeated*

Adam Smith's four maxims may well be repeated :

> 1. The subjects of every State ought to contribute towards the support of the Government as nearly as possible in proportion to their respective abilities, *i.e.* in proportion to the revenue which they respectively enjoy under the protection of the State.
>
> 2. The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.
>
> 3. Every tax ought to be so levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.
>
> 4. Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

Indisputable as these rules may be, they are now inadequate to the practical task of bringing under judgement the many difficult issues that confront us.

It is intended in these lectures to outline the questions of principle which are raised by modern developments in taxation or made obvious by the

[1] Vide *Edinburgh Review*, Oct. 1919 (S.).

intensity of the burden, and to view them under a new arrangement.

4. *A Threefold Treatment suggested: the several Standpoints*

Taxation questions may be looked at from the point of view of the taxpayer, and certain features which it is desirable either to attain or to avoid become clear from his standpoint, without complicating the issue by other considerations.

They may be looked at from the point of view of a Government, acting for the community in its State organisation.

And, lastly, they may be looked at from the point of view of the community as a producing or Economic Society. It is true, of course, that the points which are beneficial to the community, as a revenue collector, or as an economic unit, will generally also react to the benefit of the individual, but the connection is more remote. A project for taxation may satisfy all conditions of equity to the individual, but it may fail to meet the requirements of the Revenue, because it is impracticable, or wasteful, or politically inexpedient. It may even pass the first two barriers successfully, and break down because it is hurtful to the economic life of society.

Most taxes in practice represent the best practical compromise between the three standpoints that can be arranged in the particular circumstances of the time.

Such a grouping will, I believe, prove helpful in a consideration of modern problems and enable us to treat them with that isolation of effects and freedom from distraction which are so necessary to a clear conception of essentials. If the habit of examining every project or proposal from each point of view separately before passing a final verdict could be developed, there would be far less muddled counsel and confusion of judgement, and the true character of such schemes would be more easily determined.

5. *The Individual—the Benefit Principle is Natural but Impracticable*

What principles should govern the amount of taxation to be borne by any one individual as compared with that borne by another?

I think that what is known as the "benefit" principle would be the natural one to consider if it were practicable. The expenditure by the State benefits the citizens of the State, and it benefits the citizens outside the State in so far as they have property within the State. If it were possible to say *what* benefit each person derived, and to evaluate that benefit, it would be fair to *ask* for a contribution towards it in proportion to the benefit.[1] But even if it were correctly assessed it

[1] [The benefit principle might be looked at negatively, and we could declare: "if it were possible to say what cost each person had caused the State to incur, it would be fair to ask for a return of that cost." The Salter Committee on Road and Rail Transport did not recognise such a specific restoration of cost as "taxation." Licence duties and even

would often be impossible for many men to pay that contribution, and the principle as a practical principle breaks down instantly in application. First, must be decided the question whether or not to tax a man on the benefit he might receive if he liked, or only on the benefit he has actually availed himself of; for if the person who does not wish to use the Free Library does not have to pay the penny rate, it is not so much a tax-system as "co-operative reading." But the more important difficulty is that social expenditure confers benefits on poorer people which they would never pay for on the same terms as those who are better off, and which they would have to forgo if they were required to pay the price, or provides benefits which do not appeal to them personally, but are clearly advantageous socially. The expenditure for elementary education is an obvious instance. The pure benefit principle does, however, exist under "betterment" schemes in this country, and also "special assessments" in America, and we may have occasion to observe that it is rarely absent *altogether* from most forms of taxation. [The recent example in motor licence taxation is interesting. So much of the payment by a private car owner as goes to make good the wear and tear that he, himself, causes to the road is a *quid pro quo* for detriment, and hardly reaches the stage of a tax levied on the positive "benefit" principle; there is a *positive* benefit

petrol duty, which were payable for a vehicle to reimburse or in respect of the actual damage or wear and tear the payer caused to the roads, was not "taxation," and only any *excess* above such costs that went into the Exchequer for general purposes is treated as "taxation."]

derived by the user, over and above this cost, but it is not determinable, and the balance that goes to the Exchequer in support of general taxation is called "sumptuary taxation" on the ability principle—ability being tested by the possession of a car. Motor users often invoke the whole sum as "payment for the roads," or, for other arguments, as "taxation." *Vide* the Salter Report on Road and Rail transport.]

6. *The "Ability" Principle tested by Monetary Resources*

The rival principle of "ability to pay," or the faculty principle, is now almost universally recognised as the only satisfactory one for apportioning the tax burden.[1] This is generally interpreted to mean "ability" by reference to monetary resources, probably because the tax itself is payable in money. But it is not the only conceivable test of ability. If a community were independent of a monetary economy, and taxation were, so to speak, "in kind" for services to be performed for the common good, we should test ability otherwise. In the tasks requiring strength, on Adam Smith's maxim of "ability" more would be expected from the powerful man than from the decrepit, whatever their other possessions might be. In some tasks more might be expected from the taller or the swifter members of the community. In teaching the young it would be idle to expect the ignorant to

[1] *Readjustments*, p. 4.

render services equal to those given by the educated.

Swift in his great satire has a delightful account of the ideas in Laputa, which sets out criteria of taxable ability quite different from monetary ones. "I heard a warm debate between two professors, about the most commodious and effectual ways and means of raising money without grieving the subject. The first affirmed the justest method would be to lay a certain tax upon vices and folly, and the sum fixed upon every man to be rated after the fairest manner by a jury of his *neighbours.* The second was of an opinion directly contrary, to tax those qualities of body and mind for which men chiefly value themselves, the rate to be more or less according to the degrees of excelling, the decision whereof should be left entirely to *their own breast.* The highest tax was upon men who are the greatest favourites of the other sex, and the assessments according to the number and nature of the favours they have received, for which they are allowed to be their own vouchers. But valour and politeness were likewise proposed to be largely taxed, and collected in the same manner by every person giving his own word for the quantities of what he possessed. But as to honour, justice, wisdom, or learning they should not be taxed at all, because they are qualifications of so singular a kind that no man will either allow them in his neighbours or value them in himself. The women were proposed to be taxed according to their beauty and skill in dressing, wherein they had the same privilege with the men,

to be determined by their own judgement. But constancy, chastity, good sense, and good nature were not rated, because they would not bear the charge of collecting."[1]

If our taxes were imposed by reference to strength or brains, we should hesitate about courses of Sandow or Pelmanism. But in an economic community where the State wants a *general* command over goods and services, it is natural to determine ability according to wealth, and to measure it by money, although both the war and the railway strike give examples of a call by the State based on other kinds of "ability."

Personal pride is not without influence upon tax-paying ability apart from monetary tests. It has been suggested that the special air of distinction which belongs to residence in "The Gables" or "Palmerston House," instead of a plain 15 Smith Street, is worthy of recognition by the imposition of a special tax burden, which would not be "felt" in the glow of pride. Again, in some instances abroad, men have cheerfully borne a higher income tax than they would otherwise have regarded as fair, where the assessments have been published in the newspapers, and the distinction of appearing in a defaulters' list has been a doubtful punishment.[2]

[1] *Gulliver's Travels*, Part iii. chap. vi.

[2] [It has been a hotly debated feature of the "New Deal" in the United States whether the publication of income tax assessments serves a good purpose or not—it is not so completely repugnant to public opinion as in Britain. In practice the lowness of the returns due to the claiming of capital loss "set-offs" has been the conspicuous feature, and the victims have not exhibited the vanity, which suffers high assessments, suggested in the text.]

Many a man has toiled and moiled to leave a large sum at death, when its subjection to death duties has been fully compensated for by the publication of Estate Values and the strange anticipation that folk will exclaim on seeing the figures, " Fancy, old So-and-so left £23,000. I never thought he had so much." Perhaps it can be said that personal pride may be an anodyne to the so-called " hurt of taxation."

Professor Marshall says: " A person who locks up £3000 in diamonds obtains whatever social prestige may attach to the power of holding, in a sterile form, wealth that might yield, say, £120 in income. Now if a tax of 2 per cent were imposed on the capital value of diamonds the same social prestige would be derived from diamonds worth £2000 (for that would involve locking up £2000 of capital at a sacrifice of £80 of income, together with a payment of £40 in taxes), and the smaller stock of diamonds would be nearly as beautiful as the larger. A small amount of jewellery might be tax free. But lists of all taxes on it collected in each locality would be published in local newspapers, and some persons might be tempted to overstate rather than understate their holdings of it."[1] The learned professor seems to have forgotten the burglars.

Many people have, through vanity, paid on higher assessments than they need have done, but the indulgence is in these days rather expensive.

One Michael Kelly, in 1806, made a return of £500 for his emoluments, and was questioned by the

[1] *After-War Problems*, p. 325.

Commissioners, who doubted its sufficiency. He gives an account of his interview:

"Sir," said I, "I am free to confess I have erred in my return; but vanity was the cause, and vanity is the badge of all my tribe. I have returned myself as having £500 per annum, when, in fact, I have not 500 pence of certain income." "Pray, sir," said the Commissioner, "are you not stage-manager of the Opera House?" "Yes, sir," said I, "but there is not even a nominal salary attached to that office. I perform its duties to gratify my love of music." "Well, but, Mr. Kelly," continued my examiner, "you teach!" "I do, sir," answered I, "but I have no pupils." "I think," observed another gentleman, who had not spoken before, "that you are an oratorio and concert singer?" "You are quite right," said I to my new antagonist, "but I have no engagement." "Well, but at all events," observed my first inquisitor, "you have a very good salary at Drury Lane?" "A very good one, indeed, sir," answered I, "but then it is never paid." "But you have always a fine benefit, sir?" said the other, who seemed to know something of theatricals. "Always, sir," was my reply, "but the expenses attending it are very great; and whatever profit remains after defraying them is mortgaged to liquidate debts incurred by building my saloon. The fact is, I am at present very like St. George's Hospital—supported by voluntary contributions—and have even less certain income than I felt sufficiently vain to return."

7. *"Ability" tested by Income*

When Adam Smith said that "the expense of Government to the individuals of a great nation is like the expense of management to the joint-tenants of a great estate who are all obliged to contribute

in proportion to their respective interests in the Estate," he might be held to have blessed the benefit principle; but his better known pronouncement, "The subjects of every State ought to contribute towards the support of the Government as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State,"[1] is a clear enunciation of the ability principle. Moreover, we learn that he would test "ability" by reference to "revenues," *i.e.* incomes.

8. *"Ability" tested by other Monetary Measures*

People are so used to the idea of ability being measured by income that they are in danger of forgetting that there are other tests having rival claims to notice, which have indeed served as sole tests or partial tests of ability, and which have even been regarded in their place as superior tests. There is, for example, the test of "consumption," *i.e.* expenditure, whether out of capital or income and capital wealth. We are now so wedded to the income conception that even those capital taxes we possess, such as death duties, and the expenditure taxes, such as the taxes on tea, sugar, etc., we endeavour to express in terms of a tax upon income, in order to make comparisons of the total taxation borne by one class of individual with that paid by another, in relation to the amount of their respective incomes. This was recently done by

[1] Adam Smith, *Wealth of Nations*, v. chap. ii. (2).

Sir Herbert Samuel in his address upon the "Taxation of the various Classes of the People." [1] When we have summed up the taxation of all kinds borne by an "average" person with £300 a year and found it to be so much in the £, and have performed a similar operation upon the average income of £3000, we feel we are in a position to make a valid comparison, but not before. We do not find it so easy to think of the taxation borne by a *fortune* of £6000 compared with one of £60,000, probably because the great majority of people have little capital wealth beyond their home and their insurances, and our comparison would therefore be too limited. Neither does it come easy to us to consider taxation according to the relative amounts *spent*. Nevertheless there is an important school of thought which would alter the tax on incomes to a tax on sums spent, on purely economic grounds, if that were practicable. So if Brown is comparing his taxation burdens with Jones's he will make little allegation of hardship except by reference to relative incomes. "I pay £30 a year out of £400 income, whereas Jones pays only £80 out of £800." But such a mode of thought has not until recent times been common in America, nor has it been very prevalent in France.[2] The task of reducing a miscellaneous set of taxes into terms of a tax on incomes is an intricate one, rarely attempted by the ordinary

[1] *Journal of the Royal Statistical Society*, March 1919. [And also by the Colwyn Committee, 1927. *Vide* p. 81.]

[2] *Vide* article on "Graduated Taxation," by Prof. Seligman, in *Dictionary of Political Economy*; also "The Income Tax," by the same writer.

individual, and unless his thought is naturally and readily led along that line by the existence of a tax on incomes, he does not easily think of comparative hardships in that way. Mr. Hull, in introducing the United States Income Tax in 1913 to Congress, remarked, " *By this method alone* could every citizen see and know that taxes are being imposed equitably and according to ability to pay." . . . " The masses of people are now paying most of our tariff taxes, and most of our State and local taxes . . . those who have been the victims *without being able to know the extent thereof*, will welcome the proposed tax."[1]

It will probably be easiest to consider first the problems raised in the mind of the individual by the attempt to tax according to ability to pay, when it is to be achieved by a tax on incomes. This will lead the way to a consideration of the bearing of other kinds of taxation upon the problem of ability to pay.

9. *"Ability" may be subject to Five Tests*

The problem of ability to pay might appear at first sight to be adequately dealt with by putting the question, " How much have you got coming in ? " This I refer to as the *Quantitative* aspect. But under the stress of modern high rates of taxation this can only be regarded as a beginning to a series of questions, and we must ask, " Over what period ? " A commercial traveller, for example,

[1] *Congressional Record*, May 1, 1913, p. 837.

having had a fine week on the road, might be thinking only of his recent experience and answer, "I'm doing at the rate of a £1000 a year." This point must be dealt with under the heading the "*Time Element.*" Then follows the question, "Are you sure it was pure income, without any wastage or return of capital?" which is a matter to be referred to hereafter as the "*Economic*" or "*Pure Income*" aspect. Even at this stage the true verdict as to comparative ability cannot be pronounced. We must ask, "How do you get it?" because we want to know whether it has any reserve behind it, or whether its continuance depends entirely upon the continuance of the worker himself. This may be termed the "*Precarious*" or "*Earned*" income *discrimination.* Then follows the highly personal question, "Are you free to *spend* it all how you like, or have you unescapable family claims upon you?" and to this aspect may be given the title "*Domestic Circumstances.*"[1]

Finally, there would be some who would ask, "Did you get anything in excess of the sum required to induce you to give your service or lend your capital?" This may be called the *Economic Surplus Distinction.*

10. *These Elements have only recently been recognised*

A detailed consideration of these various ques-

[1] *Edinburgh Review*, Oct. 1919 (S.).

tions will be deferred, but it is quite clear that in these days we do not feel that we have dealt adequately with the question of "ability" until these several distinct aspects have been reviewed. It is not merely in the pure taxation of *income* that we now expect to find them properly recognised, but also when the whole system of taxation is reduced to its net aggregate effect upon the individual we consider the claims of justice have not been met if the differences of ability here indicated are ignored or inadequately recognised.

Now it is difficult for the rising generation of students to realise how extraordinarily complex the connotation of the term "ability" has become in the last few years. Until the end of the century any ordinary text-book, on coming to the question of taxation, informed us that our income tax was based on the principle of "ability to pay," merely because Jones with an income of £10,000 paid ten times as much taxation as Brown with an income of £1000. Apart from a little degression, and the exemption limit at the bottom of the scale, we had a flat rate of 8d. in the £, without any allowances for differences of income or personal circumstances of any kind. Beyond the scarcely heeded teaching of a few advanced writers, the great mass of the people had no instinctive feeling for anything else. All these questions slumbered peacefully under the gentle weight of such a burden, but as the pressure set up by the Boer War and the growing consciousness of the necessity for wider State functions steadily increased, one by one they woke up and became vocal,

until they reached the shrieking chorus that we hear to-day.

11. *Taxation, formerly Objective, is becoming Subjective*

It is, of course, very true that all taxation is ultimately borne by persons, although in the first place it may be laid upon things, and the whole movement of this age is away from what Professor Seligman has referred to as real or specific taxes, to personal taxes, or what the lawyers call "taxes '*ad rem*' to taxes '*in persona*.'"[1] Even our own income tax up to fourteen years ago was rather a tax *in rem* than a tax *in persona*. No one was required to make a return of his total income as an integral feature of the tax unless he liked, and he only did so to claim a privilege. Such a personal statement was incidental to the system rather than vital to it.

I believe that I was the first one in this country to characterise the change then proceeding as a transition from the "objective" to the "subjective," and the following may be quoted:

"Attention to the individual, as an interference with the main system, has grown slowly but surely until it has assumed serious dimensions, threatening the tax with Continental complexity. At first, it was required only for exemption and simple abatement. Then life insurance allowances were made contingent upon *total* income showing a certain minimum proportion. Following on, the range of abatements was twice extended: exemption from, or abatement of one-half, the Land Tax was made to depend

[1] *Readjustments*, p. 1.

upon total income; and allowances for married women's earned incomes were restricted to a fixed maximum joint total income. Then came differentiation, with its income limit, and now the allowance for children has a similar restriction, while, with the super-tax, attention to the individual and to the amount of total income becomes universal and compulsory. The total income governs three rates and a super-rate. Formerly, the assessment upon a medium-sized business, conducted by a firm, involved the comparatively simple task of ascertaining the gross liability. Now it is little short of a mathematical puzzle to divide up that liability with due regard to fixed drawings, varying partner's interest, and proportional profits; charging those for which claims have been made at one rate, those for which no claims or late claims were made, or which go to sleeping partners, at another rate or rates; and providing that all charges for interest, etc., not covered by income already taxed and received by the firm shall be kept at the highest rate. Thus gradually has the system lost the impersonal and gained the personal—one might almost say subjective—aspect." [1]

But I had not sufficient prescience to recognise that the old machine might be patched and patched and still roll groaning along its way with added complications but without actually breaking down, for the passage continued:

"It is not too much to say that disintegration, or rather chaos, will set in if there is any tampering with the *normal* uniform rate for the Schedule A assessment. There are certain popular demands that small 'unearned' incomes from personal accumulated savings should be allowed a lower rate. This could be practicable only by individual claims every year during the collection, or, for mortgage

[1] *Economic Review*, 1909, p. 410, "Economic Aspects of Income Tax Change" (S.).

interest and dividends, by repayment, involving great additions to the clerical staff. It could not possibly be automatic, a part of the general machinery of assessment. With variable gears for cycles, it is a sound principle that the gear likely to be most used, the normal, should run 'solid,' and the complicated mechanism be brought into use only with the gears used exceptionally. So all tax deduction must 'run solid' on a normal rate, but several popular ideas entail abandonment of this principle."

12. *Taxation, at first Personal, becomes Specific, and then Personal again*

Professor Seligman has very well pointed out that taxation is generally begun in its most specific form, and develops into the more personal form. "In New England, for instance, the earliest taxes were on particular things, like sheep and cows and houses and stock-in-trade; and only at a much later period do we find the general property tax, where the tax is imposed upon the individual with respect to his entire property, whether that property consists in things or in simple relations."[1] But the first approach to the personal taxation nearly always broke down. It broke down very badly in the American General Property Tax, where everything that could not be seen and handled as you walked the streets practically escaped the tax roll. It broke down in our own system of local rating, which degenerated into a tax upon houses and land.[2] It broke down in the old Land Tax which was originally intended to cover many kinds of

[1] *Readjustments*, p. 1.

[2] Cannan, *History of Local Rates in England.*

wealth.[1] It broke down in Pitt's Income Tax of 1799 which tried straight away to be a tax on the *total* income of the individual levied direct upon him. You all know that this lasted but a short time, and that as soon as the tax was made impersonal and assessed on sources of income, as far as possible allowing the burden by the principle of deduction to reach in due time and in due proportion every possible beneficiary from each source, then it became immediately a powerful engine of revenue, doubling the yield compared with the earlier scheme.[2]

Everywhere the earlier attempts at personal taxation failed. In France the personal taxes prior to the Revolution gave way to a whole group of objective taxes, but with the advance of society a new and successful attempt is being universally made towards subjective taxation and an accurate reflection of the differences of "ability to pay." The premature attempts failed for two reasons; first, the absence of adequate machinery for dealing with wealth except in its most local aspects, and, secondly, of that development in the civic consciousness, by which alone a burden can be borne, in a system which reconciles inquisitorial methods and the safety of State interests with the freedom of the

[1] Armitage Smith, *Principles of Taxation*, p. 60; Hook, "Present Position of the Land Tax," *E.J.*, 1905, p. 374.

[2] 1851 Comm., 5061. Mr. Pressley said: "In 1801, when the tax was 10 per cent and the law required that everybody should make a return of his property, the net assessment (*i.e.* yield) was £5,628,000, but in 1806, the rate then being also 10 per cent, the produce of the tax under the present principle . . . was £11,633,000." *Vide* 1920 Comm., Appendix No. 7 (g).

individual. Even the extraordinary conservatism of France, which has long been content with its rough approximation to the taxation of income by way of a group of separate presumptive taxes, is fast breaking down.

13. *A Personal Tax to be Successful must be National*

The necessary failure of all local administration to handle subjective taxation, owing to the fact that wealth becomes more and more widespread and elusive, has led to a greater reliance of local taxation upon real or specific taxes, and so, as Professor Seligman has said, "there is a double movement going on at one and the same time, a movement from personal to real taxes in local taxation, and a counter movement from specific taxes to highly sensitive subjective taxation, for the country as a whole."[1] No personal tax can be administered with safety, facility, and equity unless it covers the whole of an economic community represented by a nation. That is why, if the proposed devolution of Government in the United Kingdom is made to involve the separation of the taxation of income into three or four distinct groups under direct local autonomy, it must be a retrograde movement, and against the nature of things. It would be a sacrifice of pure taxation principles, as emerging from universal experience, to other political considerations.[2]

[1] *Readjustments*, p. 2.

[2] *E.J.*, 1912, "Irish Fiscal Autonomy and Direct Taxes" (S.). [As the Irish Free State was completely severed for fiscal purposes in 1923,

14. *The Use of Presumptions in a Personal Tax*

A proper tax upon incomes is hardly possible in a community that is not fairly advanced both in its people and in its government. Some sections of the people may not be able to give a clear account of their incomes or to have a clear conception of what is involved, and alternatively the government may not be strong or bold enough to compel declaration, even if the people know the facts about themselves. When either of these features is present there is a reliance upon " presumptive " taxes or conventional expedients. The most familiar example to us is the expedient adopted in this country because, as it is usually expressed, " the farmer does not keep accounts." He *does* not, quite frequently because he *cannot*, but there is some little improvement in this respect. I remember a farmer who was very obstinate on the question whether some mistake might not have been made in the matter of some change given to him by a tax collector, and reiterated that it " could not be so for he *kept accounts*." Interested in such a rare case, I pressed him for some explanation of his methods, which was given on these lines : " When I leaves home on the Wednesday—market day—I writes down what money I has. When I get back I writes down what I've got left. I takes one from t'other and then it shows what I've spent." On another occasion, in my days as a Surveyor in a

some of these problems immediately arose, and a " Double Taxation agreement was necessary.]

rural district, a farmer claiming to have made a loss filled up the simple form of account then officially provided, and showed the value of his live stock at the beginning of his farming year. As he had made a similar claim in the previous year, the accounts were compared, and he was asked, without being given the figures, why there was such a difference in the value of his stock on the night ending the one year, with that shown in the morning beginning the following year. Nonplussed for a moment, he quickly remembered that "that was the night of the thunderstorm." Unfortunately for his explanation, the stock on the value shown in his accounts had *increased* in that fateful night! Whether simple or cunning, the farmer's case has been met for over a century by a conventional or presumptive tax. At one time his profits were assumed to be three-fourths of his rent, then one-half, and for a long time one-third. In recent years the presumption has been increased to a sum equal to the rent, and now it stands as double the rent paid. The assessments upon small retail traders have often approximated to presumptive methods, for the traders themselves have but little idea of anything but their turnover, and even then the "missis goes to the till." So the revenue official, meeting the case with a round figure based on such evidence as may be available, has a better idea than the man himself of the annual earnings.

In Canada, when they were feeling their way cautiously towards an income tax, it was proposed to establish by samples in each class of business the

average ratio borne by the rental value of premises occupied for business, to the profits of the business, and to produce a sort of index or factor which might be applied in all other cases in order to ascertain or estimate profits.[1] Unless businesses were very similar in size and also similarly situated, the method, like the method of dealing with farmers' profits, is innocent of all recognition of the principles of economic rent.

In France, before the introduction of the present income tax, the effect of an income tax was sought to be obtained by presumptive or objective taxes —often referred to as the "four old women"—on real estate, personal property, a licence tax on business and professions, and a tax on doors and windows.[2]

There is no country in which the whole system of taxation is one, logically worked out from first principles. Everywhere the accidents of political and commercial considerations in past history are perpetuated, and condition the present systems. But there is little doubt that these are gradually gravitating towards one or two common main types in which personal taxation of income is taking the predominant part, while various systems of indirect taxation and tariffs are taking a less important place relatively, even though their absolute yield is maintained.

[1] Vineburg, *Provincial and Local Taxation in Canada*, p. 59.

[2] Kennan, *Income Taxation*, p. 79; *For. Income Taxes*, 1905, p. 142.

CHAPTER II

THE INDIVIDUAL STANDPOINT FOR THE TAXATION OF INCOMES

It is proposed in the second and third lectures to consider the principles of taxation as they arise from the viewpoint of the individual taxpayer, without regard to the convenience of the State administration or to its efficiency, or to any particular effects upon the business community. As has been remarked already, many of the principles are most clearly seen in the study of the taxation of incomes, and the present treatment will be devoted to that special aspect of the matter. It is not my intention to make a detailed inductive study of all the different schemes in vogue, but rather to set out abstract principles, and illustrate them occasionally from the present state of taxation at home and abroad.

1. *The Measurement of "Ability" by Time: the Power to " Carry Over "*

Before " ability " can properly be tested by " income " we must have a unit of time, a definite conception of what constitutes income, and the measure of its amount. If there are different

measures of amount for different purposes we have to consider which is the most appropriate for the reflection of relative "ability," and also, in view of the standpoint of the State, which can most practically be compassed by its administration. Then follows the application of the various aspects of ability to which reference has been made.

We are so used to considering income "by the year," that it seems to be almost an ordinance of nature. Yet vast numbers think only of their weekly wage, and could not readily say what their yearly income is. Those who think in terms of annual income plan their expenditure very much upon a yearly basis, without special regard to monthly fluctuations due to holidays, or the winter coal and light. Their ability to pay an annual tax can clearly be measured in the same way. But the weekly wage-earner's outlook is much more limited —he may be relatively prosperous and relatively depressed within a short space of time, owing to an alternation of overtime with short time; his tenancy is weekly; and he has relatively little power of "carrying over." His ability cannot be held in suspense. Often his only means of looking well ahead is that provided by coal clubs, holiday clubs, and the like. His "ability" to pay taxation must be measured by a shorter term. That is why some people who favour a graduated deduction from wages by a stamp system, instead of an income tax, regard the annual income as quite incongruous for the conditions to be met. By the time the money comes to be paid, the facts of the moment

are quite out of accord with it, whereas deduction must always exactly fit the ability. The quarterly methods actually adopted in this country are some recognition of the principle involved.[1] But the high rate of tax is bringing the time question in regard to ability into prominence in other ways. The "base" of the tax must be a long enough period to give a fair average indication of means—the base upon which a man's household and conditions of life are naturally laid out—but it must not be so extensive that the time for paying a tax does not follow closely upon the period over which it has been computed. It is for this reason that many people are now calling into question the three years' average system. If a man has profits for 1917 of £1000, for 1918 of £3000, for 1919 of £8000, and for 1920 of £12,000, he is called upon to pay during the year 1920, on £4000 income, some £1200 in tax, or only 2s. in the £ on what he is receiving *at the time of payment*, whereas if the sequence of profits were reversed, but the total remained the same, he would be called upon to pay on £7666 income, some £2300 in tax at a moment when his current ability is measured by £1000 a year income only. Of course in theory he should save up the tax during the prosperous time, and have it ready to hand out during the lean time, but human nature being what it is, such a proceeding is the counsel of perfection for many men, and in practice one must expect a clamour for relief in the latter case, with no corresponding provision for the State to benefit

[1] 1920 Comm., Q. 25,248—Report, Section viii.

in the former. It is, therefore, " heads-I-win-and-tails-you-lose " for the individual taxpayer against the community of taxpayers. The operation of the Super-tax one year later serves to aggravate the trouble. The movement in favour of taxing on the actual profits of the preceding year in this country as is commonly done abroad, so that the tax follows hard upon the profit to which it relates, and the punishment fits the crime, has been growing in force.[1] But in this as in other things, human nature is prone to feel its hardships more acutely than its blessings, for Professor Haig told me recently that the United States were seriously considering abandoning the "previous year" method for our average system. The " average " method has one important feature, which has generally escaped notice. It lessens the actual burden of tax because it lowers the rate of tax on a progressive scale.[2] The duty chargeable upon £2000 per annum made in three successive years will be considerably less than that chargeable over the three years if the profits are £1000, £2000, and £3000 respectively. The truth is probably that an average more properly indicates the economic *ability* of well-to-do people, but that we come into conflict with another of Adam Smith's canons, that of convenience. Nearly all taxation in practice is a compromise between two or more ideal positions.

[1] 1919 Comm. The majority of the witnesses pressed for a change, p. 105. [The change was duly made in 1927 and the supertax, now surtax, though payable later than the income tax, is computed on the same basis. Special provision is made for carrying forward actual losses against future profits.]

[2] *Ibid.* Qs. 11,155-9.

The foregoing remarks apply, of course, only where the individual is directly assessed, and such questions of principle do not arise so clearly in the assessment of companies, where the "ability" of the individual is in question only as he receives his taxed dividends. So it is not uncommon for the average to apply to companies in the continental systems, although the single year is the general practice.[1] In Prussia the average was abolished for individuals, but retained for companies, in 1916. Probably the ideal course, though not always the most practicable, would be to adopt the *current* year as the basis for companies.

2. *The Time Element in Relation to Fairness and Convenience*

The principle of convenience in fitting the appropriate tax to the appropriate profit as closely as possible was effected in the British Excess Profits Duty by the separate assessment of each accounting period, whether for a quarter, a half-year, a year, or some irregular period, for each business, as the smallest unit of assessment, immediately its accounts were closed.

The principle of average rather than fluctuating "ability" was responsible for the provision for equating the results, and for setting off deficiencies against excesses, which was practically confined to the British scheme. Under the American scheme, where the excess of profit above a certain interest on

[1] *For. Income Taxes*, 1913, p. 24.

capital employed was charged according to a graduated scale, each year's result necessarily stood by itself, and could not conveniently be merged with others. This meant, of course, that fluctuating businesses paid, in the long run, a higher amount of tax than businesses in which the same aggregate profits were made more evenly.

Companies have a power of holding their "ability" in suspense to a much greater extent than individuals. But even there, under strain, limits will appear. When the Munitions Levy was brought in, the whole machinery for imposing what was generally described as a "tax"—despite any argument to the contrary which might be derived from the Parliamentary procedure which attended its introduction—had to be improvised and worked out and the tax administered by persons who were amateurs at such work, while, in the meantime, the regular administration of the Excess Profits Duty on controlled establishments was held in suspense.[1] The very considerable delay that ensued in making the assessments for any given period, left the Companies with their profit resources for that period held in suspense for such a length of time that the importance and weight of the impending State claim for taxation was lost sight of in the immediate pressure or advantage of other possible uses for the money. So when the State called for its tax it found in a vast number of cases that the Company was "unable to pay," because the money was by that time represented by new buildings and plant.

[1] Vide *Hansard*, 3rd May 1917, and debates *passim*.

The State has had great difficulty to get its money,[1] for there is never the same readiness to raise new capital for the payment of taxes or debts as there is for permanent extensions and fixed assets. Of course, the deduction of tax at the source when the recipient receives his income is the closest possible "fit" of taxation to ability in point of time; but only if ability is regarded as satisfied by *proportional* taxation. The satisfaction of ability by *progressive* taxation is badly served in this respect, because it is only for a few people that the rate of tax deducted corresponds to the rate actually to be borne by them after adjustments or repayments or further charges have been made.[2]

3. *Conception of Income: (1) The Idea of Money Received*

Some people think that "an income" is something saved, others that it is something spent. We can appreciate the point of view of the wage-earner who exclaimed, "Income! 'ow can a man have an income when he's got nine children?"

There will always be room for great difference of opinion and national practice in drawing a working

[1] [Fifteen years after the Duty had ceased the Budget was bringing to account some two millions sterling per annum for arrears.]

[2] The recommendations of the Royal Commission of 1920 (on the subject of graduation) led to the deduction of the "standard rate" being finally correct over a much wider range of income. [A still closer fit to the current circumstances is made by the rate of tax deducted from dividends. Formerly, the rate of deduction had no reference to the rate in force at the time the payment was made, but was the average of rates in force *over the period* during which the profits were made out of which the dividends were paid. Now, the date of *payment*, not the period of earning, decides the rate of deduction.]

line in that uncertain region lying between unmistakable "income" and unmistakable "capital" in an economic sense. When we have to decide what "means" or what "revenue" shall be taken into view in considering tax-paying "ability," the room for difference is wider still.

Every one must live in some house or other, and therefore a payment for rent can be regarded as normal or essential out of every income. If a man lives in his own house and pays no rent, should the rental value be treated as income? A. has £400 salary and £40 from dividends on £800 stock, and he has to pay £40 out for the house he lives in. His net income after paying rent is £400. B. has £400 salary and £800 in a house, worth £40 a year, which he lives in. His net income free from the rental is also £400. In this country we think instinctively that the two cases have the same "ability" and that each has an income of £440 per annum. But such a view is by no means one of the innate ideas in human nature.[1] In America, the idea of annual or rental value is by no means so common as here—property is bought and sold freely, and it is taxed for local purposes on its capital value, so that the average American thinks first of the capital value, and if he thought at all of the annual value he would get it from the capital value, whereas we normally think first of rental value and derive capital value from it. Professor Plehn has asserted that not more than one per cent of the assessors in the United

[1] *E.J.*, 1913, p. 3; *Annals of the American Academy of Political and Social Science*, March 1915, p. 3.

States are familiar with the conception of annual value.[1] It is small wonder then that when a scientific income tax on modern lines was first introduced in Wisconsin in 1911 popular opinion was against counting the homestead as income, and a great deal of education in a paternal strain from the administration was necessary before the strange idea was assimilated.[2] In the Western Australian Income Tax there is no provision for charging the annual value of a residence. But of course we are not strictly logical: why should not the annual value also of our furniture be counted as income? If the habit of hiring furniture were common, and the ownership of it exceptional, it would be just as easy a notion to accept. [The British would not include garden produce raised by an ordinary resident in his income, but if computing a farmer's profits, his personal consumption of produce would not be allowed as a business expense. In the United States the farmer is not taxed on the crop consumed, but he may not deduct the expense involved in raising it. In 1936 it can still be said that few other countries include house rent, and almost none farmers' produce, in taxable income.[3]]

In most countries income received in kind, such as free lodging, board, etc., is regarded as taxable, but not so in this country. Some countries are much more stringent than others in charging the profit from occasional dealing in stocks, shares, or

[1] *E.J.*, 1910, p. 8.

[2] *E.J.*, 1913, p. 3.

[[3] Seligman, *Encyc. of Social Sciences.*]

property, etc.,[1] but in this country we do not regard them as forming part of "income" ability unless they constitute more or less regular practice amounting in effect to a business.[2]

When we come to deal with regular receipts which contain capital elements, the scope for argument is very wide.

4. *Conception of Income: (2) The Advantages of "Co-operative Action"*

At the present time feeling runs high upon the subject of the co-operative "divi." Is the "dividend" or "deferred discount" which a member of a co-operative society receives out of the surplus of profit of the society, in proportion to his purchases from the society, "income" which ought to appear in his statement of income as a representation of true ability? If one workman earns £156 a year and has £10 "dividend" because he spends his wages at his co-operative store, has he a greater ability to pay taxation than another workman who also has £3 a week and buys his things at the ordinary shops? "Yes," says the anti-co-operator, "certainly he has. He adds to his wages a profit from mutual trading, competitive in its essence." "No," says the co-operator. "If a man makes or does something for himself, such as repairing his own boots, instead of sending to a bootmaker, he does not make a profit out of his own labour." Similarly if two join together to serve each other, no profit arises. The anti-co-operator urges that

[1] *For. Income Taxes*, 1913, p. 20. [2] 1920 Comm. Report, p. 20.

profit arises immediately mutuality commences, and there is only a question of degree between the case of two and that of the whole nation trading together. There are other arguments of a political and economic character for the taxation of co-operative trading, but I am referring here to the conception of income. The chief practical difficulty that arises in fitting this case into the ordinary definition of profit or income is that in the net effect a man may get his goods at an average cost price whether the original charge be at cost and the dividend *nil*, or the charge be moderate and the dividend moderate ; or, again, the charge the general market value and the dividend the commercial profit ; or the charge very high and the dividend very high : in fact if you rest on the actual amount of the *Dividend* your profit may be anything you like to make it by arrangement in your books—it is arbitrary. The Income Tax Committee in 1905 reported :[1]

" The suggestions made to us that the ' dividend ' which is paid to members of these societies constitutes a profit which would properly be taxable, rest, we think, on a misapprehension of the nature of the dividend. The so-called ' dividend ' arises from the fact that the prices charged by the society to its members are in excess of cost price. If the goods were distributed at the exact price, there would be no ' dividend,' and it follows that no question of income tax could arise. But the societies, for what they consider good reasons, prefer to fix a scale of prices which leaves a margin over and above cost. Thus an adjustment has to be made periodically, and the balance between cost price

[1] 1905 Comm. Report, par. 136-7.

and distributing price is divided among the members in proportion to the value of their purchases. This 'dividend' is clearly not profit, but merely a return to members of sums which they have paid for their own goods in excess of the cost price. There can be no doubt that the procedure which we have described—resulting as it does in periodical returns to members—is conducive to thrift, and we see no reason for discouraging it."

"A Society may, however, of course, make profit on dealings with non-members. This profit is, in the case of most ordinary societies, very small in amount. But, so far as any such profit is made, and so far as any interest is paid on capital, if that profit or interest comes into the hands of any person whose income is over £160, it ought to be, and it is, taxable."

If this mutual trading is regarded as income the only escape from arbitrariness in application appears to be to disregard the amount of "dividend" and treat the profit as the difference between the net cost to the member and the full market price, neither more nor less.[1] Some analogous considerations arise in considering the "cost" of life insurance, where high bonuses and high premiums must be considered together.

The current questions are not so much those of definition as whether participation in such methods of supplying our needs do or do not increase tax-paying ability.

[1] A fuller discussion of that economic conception of income which would cover the advantages derived from co-operation, may be found in the reservation to the Report of the Royal Commission on Income Tax, 1920, signed by the present writer. *Vide* p. 166. [There has been further technical adjustment of the liability of Co-operative Societies since.]

5. *Conception of Income:* (3) *Municipal Trading*

Where the profits of municipal trading are charged to any income tax there may be a useful payment to public revenue unconsciously borne by the community which it is unwise to disturb.[1] In the abstract, however, the actual effect is that if the tax were *not* charged the profits would be larger, and therefore, where applied to the relief of the rates, these rates would be lower. In this way every ratepayer is paying the income tax at a flat rate. But some ratepayers should be exempt and others should pay at a high rate, whereas if the incomes are roughly proportioned to the rental values of their dwellings, the charge is at a uniform rate, and has no regard to the finer tests of ability to pay. The taxation of such profits therefore appears to be unscientific in its ultimate basis, from the individual income point of view, whatever may be said from the other standpoints. One of the reasons usually urged for charging municipal profits is that otherwise they would get an unfair advantage over private trading profits. This, however, seems to assume that income tax enters into costs, and that if a man has less to pay he can afford to charge less—a doctrine that has more popular sentiment than economic reason behind it.[2] The Australian Commonwealth and the provincial Governments do not charge municipal revenues. When our Excess Profits Duty was imposed, it was provided that the

[1] 1920 Comm. Qs. 12,983-6. Qs. 11,455-66.

[2] [Fully examined and reported upon by the Colwyn Committee, 1927.]

sinking fund charge might be a deduction from profits, where any portion of it fell upon the rates, otherwise Excess Profits Duty would have been payable on an "excess" which was merely the difference between a sum now raised out of rates and the larger sum so raised before the war, and the Excess Profits Duty would most obviously have increased the rates.[1]

6. *Progressive Taxation based on the Principle of Diminishing Utility*

When Adam Smith referred in his first canon to contribution "in proportion to their respective abilities, that is in proportion to the revenue enjoyed," it may be considered that no warrant was given for a progressive rate of taxation, and that he had distinctly in view a proportionate or flat rate. Thus £1000 taken from an income of £10,000 would be in *proportion* to £100 taken from an income of £1000. But in another place he seems to lend countenance to progressive rates, for after the assertion, surprising to us in these days, that the proportion of income spent in house rent to other expenses is highest among the rich, so that a tax on house rent would in general fall heaviest upon the rich, he says: "It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more in proportion."[2]

[1] Vide *Hansard*, 7th Dec. 1915. 1341.
[2] *Wealth of Nations*, V. ii. part 2.

Progressive taxation of income is now wellnigh universal, and it is difficult to realise that only two decades ago it was still looked upon askance by all but advanced thinkers in this country, and in France it is still viewed with much suspicion.[1] The nineteenth-century economists in the main accepted proportion with an element of degression and an exemption limit, and they regarded any departure from a plain proportional rate as a dangerous and socialistic step leading to confiscation. In 1861 Mill said: "The rule of equality and of fair proportion seems to me to be that people should be taxed in an equal ratio on their superfluities, necessaries being untaxed, and surplus paying in all cases an equal percentage. This satisfies entirely the small amount of justice that there is in the theory of a graduated income tax, which appears to me to be otherwise an entirely unjust mode of taxation, and, in fact, a graduated robbery."[2] In his *Principles of Political Economy* his language is less forcible.

At the same date, Newmarch said graduation was "confiscation, punishing prudence and virtue, taxing a man for being good to himself and doing good to others."[3]

The best known early nineteenth-century view is M'Culloch's oft-quoted remark, "When you abandon the plain principle (of proportion) you are at sea without rudder and compass, and there is no amount of injustice you may not commit." Curiously it

[1] [In France the law of 1917 applied a maximum rate to all incomes over a certain level, and allowed a deduction of one twenty-fifth of taxable income for each additional *lower* level.]

[2] 1861 Comm. Q. 3540.

[3] 1861 Comm. Qs. 747-50.

was M'Culloch's view that the taxpayers should be left in the same *relative* position in which they had been found. Those who thought of this tax as a definite *payment,* like Sargant, said there was nothing to justify asking a rich man for a shilling for what another gets for ninepence.—One wonders whether Sargant had ever paid a doctor's bill!

Although a progressive produce tax existed in Athens six centuries before Christ, and possibly an income tax in Egypt a thousand years earlier, while in this country there was progression in the fourteenth and fifteenth centuries,[1] the idea only took root sporadically so far as incomes were concerned. In the French tax on a tenant's rental, progression was designed to secure a proportional tax on the income because the ratio of rent to income fell as the income got higher, and also, as Seligman says, "to compensate the lower classes for the other duties."[2]

The principle of progression has, however, never lacked exposition from the time of Montesquieu. Paley, in 1830, gave the first complete English exposition — "We should tax what can be spared." The Dutch writers proceeding from the exemption of the subsistence income gradually reached progression with mathematical forms.[3] By 1894 Seligman, surveying the whole subject with the growing continental practice, was able to urge that the apparent stability or certainty of proportional taxa-

[1] *Vide* Kennan, *Income Taxation,* chap. i. Also article on "Graduated Taxation," by Prof. Seligman, in *Dictionary of Political Economy.*

[2] Seligman, *Income Tax.*

[3] Seligman, *Progressive Taxation.*

tion might really involve the greater arbitrariness, and that the "confiscation" objection had been answered.

The application of progression in the British income tax was delayed far beyond that in the German scheme, probably because the latter system of direct taxation on the individual lent itself more easily to the principle on its practical application than the British system of taxation at the source, where the difficulties are very real, and led to a compromise even at that date.

It was not until the marginal theory was thoroughly worked out on its psychological side that progressive taxation obtained a really secure basis in principle. It seems to us now a bare truism to say that taxation is a sacrifice or a "hurt," and that to take away a shilling from the 10,000th £ is not so hurtful as to take a shilling from the 100th £. The principle is based upon the diminishing utility of money or wealth as a whole to its possessor. While the utility of increments of any *particular* commodity may rapidly diminish, and reach zero or even *disutility* (as when a schoolboy has exceeded a fourth helping of plum pudding, or as when we have heard "The end of a perfect day" indifferently sung for the hundredth time), the utility of commodities *in general* does not reach zero so readily. The utility of money, therefore, while continually diminishing to the individual possessor as he has more and more, does not actually become *nil* until the aggregate is enormous, and possibly not even then, for even if a man is surrounded with

everything that money can buy, an additional sum may still have some value to him as ministering to his *pride*.

7. *Progressive Taxation has also been based on Increased Productivity*

It must not be forgotten, moreover, that progression has been justified on the "production" side by reference to the fact that the larger the income the greater its power on being focussed or grouped for the production of further income, and therefore, the more it can be tapped without hurt. This cannot, however, be said to apply to a large income made up of various mixed investments, but only to a business income in the hands of a powerful and highly intelligent direction. This justification has been put forward quite recently for the progressive taxation of businesses according to their size, reckoned by their capital.[1] This, indeed, would be the only way in which the ability arising through power of aggregation could be reached. But if the larger business is not in fact more profitable—what then? If its proceeds formed part of a large number of smaller incomes, the ability, tested on the spending side, is in direct conflict with ability on the production side. But at any rate it may be conceded that direct progressive taxation of businesses is the only true way of reaching greater ability on the "production" side of wealth.

[1] *E.J.*, 1919, p. 419 (S.); *Political Science Quarterly*, March 1918.

8. *Progression has been alleged to be justified upon the "Rental" Conception in Economic Theory*

The latest justification of progression is Mr. J. A. Hobson's doctrine of the taxation of surplus: If the price or reward of a given factor in production, whether interest or wages, is fixed by the reward payable to the marginal supplier, the superior reward paid to a person with a position of advantage is in the nature of economic rent, and as its withdrawal would not lead to the withdrawal of the supply, it is capable of bearing taxation without further shifting. Mr. J. A. Hobson is, perhaps, our most thoroughgoing exponent of this analysis, and he divides the reward paid into "costs" and "surplus." The taxation of costs cannot in direct theory be achieved—it is thrown off, either because the reward *essential* to maintain the offer is diminished and the offer is withdrawn, or because the efficiency of the agent offered is diminished. For example, if a man is having a bare subsistence wage he may be made to *pay* a tax, but the final burden of it is shifted to the community, for his diminished efficiency reacts on price. Similarly, if the minimum interest which induces a given bit of saving is encroached upon, the saving is withdrawn, the supply of capital diminished, and its general price to others increased. But where tax falls on "surplus" it stays there.[1]

If no economic friction existed, taxation would rebound continually from all elements of costs,

[1] J. A. Hobson, *Taxation in the New State.*

shifting and shifting until it all rested finally in "surplus." But friction exists to a most important extent, and there is a rival tendency for taxation to stick where it is first laid on, so that the theoretical result is not achieved, even imperfectly. Mr. Hobson admits that "at present it suffices to register a clear judgement to the effect that it is not feasible or equitable to attempt to earmark and attack for revenue the separate items of surplus as they emerge in the present distribution of rent or dividends or profits."

As the test is not quantitative, it is not possible to discern easily which elements of income possess this peculiar quality of final inability to shift taxes, and which are pure costs. The principle of surplus is therefore not available directly as a practical canon in taxation. But Mr. Hobson presumes that these rental or surplus elements are more likely *prima facie* to exist in the incomes of larger amount —the larger the income the greater the *proportion* of it which is rental and not costs—so that a progressive income tax in a rough way is taxation on the principle of surplus. But in my judgement this assumption is so little likely to accord with the facts that a progressive tax can hardly be based upon it. For an income of £1000 from a happy investment in oil or rubber contains a great deal of surplus, whereas an income of £10,000 from house property or consols contains none at all.[1]

Another writer, R. Jones, boils down all the

[1] These paragraphs are reproduced from an Address to the British Association. Vide *E.J.*, Dec. 1919.

principles of taxation virtually to one, which is "for the State to take the least useful parts of incomes," which taken in a national rather than a personal sense almost comes to the Hobsonian position.[1]

9. *Objections to the "Diminishing Utility" Basis for Progression*

The principle of regular diminution of utility has not been unchallenged. Sir Sydney Chapman has urged that different schemes of consumption are as a rule variations of certain distinguishable types, which are kept comparatively intact over lengthy periods by habit and social assimilation, though they are never so well defined that their existence cannot be overlooked. Objectively viewed these types may merge into one another, but subjectively —to the individual—they exist as discontinuous. People usually advance in the social scale by distinct steps. He then considers the case of men spending different incomes but aiming at a specific standard of £300 a year, and I have elsewhere dealt with the same idea.

"I do not of course carry this principle of action so far as to distinguish between two incomes of £500, one of which is going to a man who is always 'hard up' because he happens to be at the lower edge of a social group whose habits, etc., are conditioned by incomes falling between £500 and £1000 —say £750 average; while the other income goes

[1] R. Jones, *The Nature and First Principle of Taxation.*

to a man who would 'feel' the payment less because he lives on the upper side of a group whose incomes range from £250 to £500, with an average of £350. Such differences in relative sacrifice can never be objectively measured." [1]

You will now understand what Sir Sydney Chapman means when he says that this view involves the hard saying that the marginal utility of money may be greater to a man after his circumstances have improved! "It is a common experience to meet with people who have attained a slight accession of income and whose enjoyment of life has obviously been increased quite out of proportion to the accession of income." [2]

On the practical side Chapman agrees that the difficulty cannot be recognised, and the State must be no respecter of persons but adopt the same fiction as is essential in so much political doctrine and deal with a mode or average type for the whole class. But he challenges the ordinary presentation of diminishing utility on the lines of diminishing sacrifice to the individual, and prefers to put it that wants satisfied by earlier increments to income are of more importance than the wants satisfied by late increments, whether the satisfaction of the former causes more utility or not. We must judge of the value of satisfaction of wants in a moral scheme of consumption. Although this idea works well for a comparison between an income of £200 and one of £2000, it is really only a new way of expressing the degressive idea; and it does not seem to serve us

[1] 1920 Comm. Q. 9603.

[2] *E.J.*, 1913, p. 30.

very well in establishing a charge upon £200,000 at a higher rate than that upon £50,000 per annum when one can hardly distinguish the difference in the social importance of the wants satisfied.

10. *Graduated Taxes in Practice*

Once grant that some form of progressive taxation is proper, what form should it take? This is perhaps one of the most important problems of the moment, and it is said to put the supporters of the diminishing utility principle in a dilemma.

This diminishing utility may be pictured in two ways, as in the table opposite, assuming that it diminishes "*in the same ratio.*" The first column sets out one meaning, viz. that a 2s. drop (or one-tenth) in the utility per £ at £1000 is matched by a similar drop of one-tenth at £2000, and again at £3000. Of course we soon reach finality, viz. at £9000. The second column shows the *kind* or type of diminution which, I believe, correctly represents our psychology (viz. a deduction of a constant *fraction* from each *foregoing* stage), and that is one-tenth. The 2000th £ is assumed to have one-tenth less utility than the 1000th £, the 3000th £ one-tenth less than the 2000th, and so on. In this way zero is constantly approached but *never* actually reached. You can even increase the "one-tenth" fraction at each stage (say, one-ninth at the 2000th £) provided always that the increment in the fraction is a continually diminishing increment.[1]

[1] 1920 Comm. Q. 9606.

DIMINISHING UTILITY OF MONEY

" In the same ratio."

£	Method 1	Method 2
		One-tenth less of the preceding.
100th	£1	£1
500th	18s.	18s. 1·8
1000th	16s.	16·2 1·62
2000th	14s.	14·58 1·458
3000th	12s.	13·122 1·312
4000th	10s.	11·810 1·181
5000th	8s.	10·629 1·063
6000th	6s.	9·566 ·956
7000th	4s.	8·610 ·861
8000th	2s.	7·749 ·775
9000th	*nil.*	6·974

If taxation, based on the second column of the above, took away x from the 3000th £ it would have

to take away $\frac{13 \cdot 122}{6 \cdot 974}x$ at the 9000th £ (or nearly $2x$) to deprive the owner of the same "utility," and that equality of deprivation is the rationale of progressive taxation.

Based on this principle the usual curve shown in graph form, which gets flatter, but never quite horizontal at the highest points, is justified.

11. *Progression justified as an Engine of Social Improvement*

Until recent years there has been a kind of tacit understanding that to have any other objects than pure revenue was at least impolitic and possibly even wrong. But opinion of late years has developed rather towards the position that if the State follows too closely the ideas of pure equity, it is practically handicapping existing rights, that is to say, it is acquiescing in the view that here in the twentieth century "all is for the best in the best of all possible worlds."

It is now considered that the State may have a duty to develop in a direction away from the existing state of affairs, towards a better; or, to use Professor Marshall's words, "to use its powers for prompting such economic and social adjustments as will make for the well-being of the people at large."[1] Now, of course, one of the most important powers of the State is its control over taxation, and therefore we begin to lean towards the use of

[1] *After-War Problems*, p. 317.

taxation in a national problem of dynamic effects. [By 1935 the average opinion is thus stated by Professor Seligman: "While the redistribution of wealth must always be a secondary aim compared to this purely fiscal purpose of taxation, progressive income taxes *possess the merit* of counteracting the tendency toward a greater disparity of wealth." But the highest rates, reaching 60 per cent and over, are confidently claimed to be causing family redistribution and leading to devices for legal avoidance on a wide scale.] Proceeding from a kind of postulate that the upper classes have no such excess of happiness over the lower classes as might be expected from their better material position, Professor Marshall develops the view that one does relatively little hurt by actually taking away the gratifications of the former, as compared with the real hurt of touching the latter classes. The whole of a very small family income is put to good use, and should make little or no contribution to the revenue. "It will not be possible to abstain from taxing all the things consumed by them, but the greater part of what they contribute directly should be returned to them indirectly by generous expenditure from public funds for their special or even exclusive benefit." He concludes that the ever-growing public expenditure on old age pensions, etc., is not a *charge*—it is merely good business, for the lives of the genuine workers as happy and free citizens are an intrinsic part of the national life, with which the wealthy could not dispense. Professor Marshall says that the hurt caused by obtaining £1000 of

additional revenue by means of levies of £20 from incomes of £200 is unquestionably greater than that caused by taking it from an income of £10,000. Looked at thus in the aggregate, it has been termed "least aggregate sacrifice." The only check upon this process is the economic effect on capital of excessive taxes, which may react on the people at large. It does, however, justify a very large graduation of the additional burden. The only kind of taxation which can really achieve it, is direct taxation of income and property: for taxation upon consumption through commodities has never yet been made to reach the rich progressively, as compared with the poor.[1]

This conception of "hurt" is one against which we must be on our guard. There is in connection with all that follows on this line, something akin to what medical men call "tolerance," and it is only upon the first few impacts of new burdens that the conception really assists us much. Canard said, "Every old tax is good, every new tax is bad, but the new becomes good in time."

When one's station of life has become thoroughly accommodated to a certain burden, the word "hurt" is inappropriate—it does not express that difference between our state of feeling in the station we actually occupy and what we should feel like if we had no taxes to pay. One might almost as well describe the difference between our present happiness and what we might enjoy in Paradise as being a "hurt."

[1] *Loc. cit.*

If the civic sense is sufficiently developed, taxation may tend to have less and less the aspect of "hurt." There may be so much of what economists call "consumers' rent" in the price paid for the State advantages that it is a misnomer. Of course we want to get a given boon for as little outlay as possible, and the lower the price the greater the "consumers' rent." But is the difference between two "consumers' rents" a *hurt*? Sir Leo Money recently told the Royal Commission on Income Tax that his taxation was the best expenditure he made, and he got most satisfaction for it.[1]

But as soon as we approach the standard of life with a view to reducing it, then the conception is applicable and the term "hurt" has a real aptness so long as the memory is an enduring one. In the words of the poet, "Sorrow's crown of sorrow is remembering happier things." Fortunately the memory is short, and tolerance saves us from a long succession of pains.

It is quite clear that the two main principles of graduation which can be derived from the principles of diminishing utility are those of "least aggregate sacrifice" and "equal sacrifice," and the former is the more dangerous because it seems to be more arbitrary. It certainly leads to pure confiscation of income at certain levels, whereas the latter can hardly be said to take away the whole of any additional part of income however great the wealth. Thought is at the present time moving so actively in this direction, that the misgivings of some

[1] 1920 Comm. Q. 10,765.

antagonists of graduation, during the nineteenth century, seem to be fully justified.[1]

12. *The Difficulty of fixing a Scale of Rates by Formulae*

It will now be obvious that the increment in the rate must be a diminishing increment, and there are various schemes for getting curves which will, with the same mathematical functions, achieve three ends, viz. (1) serve the needs of the mass of incomes from £200 to £2000, (2) not become too nearly proportional at a high level, and (3) not end in taking 20s. in the £ at a certain level within the range of a (humanly) possible income, or, indeed, not collapse under the weight of its own mathematics and return to the millionaire his whole tax. One such formula, in recent years put forward by a Member of Parliament, played some strange tricks when it reached the high incomes.[2] In this country we have a wholesome terror of algebra, and even if we rested

[1] *Vide* Professor Edgeworth, 1920 Comm. Q. 11, 785. [Also my discussion of "The Distribution of Incomes" in *Journal of the Royal Statistical Society*, May 1936.]

[2] *Hansard*, 13th July 1914, col. 1536. The formula provided for ascertaining the rate, on an income of x pounds, of y pence in the £ as follows :

$$y = 8\frac{(x-10{,}000)(x-50{,}000)(x-100{,}000)}{(3000-10{,}000)(3000-50{,}000)(3000-100{,}000)} + 12\frac{(x-50{,}000)(x-100{,}000)(x-3000)}{(10{,}000-50{,}000)(10{,}000-100{,}000)(100{,}000-3000)} + 15\frac{(x-100{,}000)(x-3000)(x-100{,}000)}{(50{,}000-100{,}000)(50{,}000-3000)(50{,}000-10{,}000)} + 16\frac{(x-3000)(x-10{,}000)(x-50{,}000)}{(100{,}000-3000)(100{,}000-10{,}000)(100{,}000-50{,}000)}.$$

It works satisfactorily in the lower ranges, but at £30,000 the rate is 16·6d., and at £80,000, 11·6d., rising to 240d. at about £180,000, and thereafter with gigantic strides.

our tax scale upon a curve, that support would have to be carefully kept out of sight. It is to be wondered whether our House of Commons would ever be induced to incorporate a curve of the third or fourth degree in an Act of Parliament. May I note the courageous effort of the Australian legislature :

Where R = rate of tax in pence per £, and I = taxable income in pounds sterling. For incomes exceeding £2000 : For so much as does not exceed £6500 the rate is obtained thus :

$$R = \frac{1}{30}\left(\frac{I}{1000}\right)^3 - 1\tfrac{1}{5}\left(\frac{I}{1000}\right)^2 + 12\tfrac{7}{12}\left(\frac{I}{1000}\right) - 5 + 5\tfrac{8}{15}\Big/\left(\frac{I}{1000}\right),$$

and for every £ in excess of £6500 the rate is 5s.[1]

This may satisfy the canon of ability (though even that is doubtful, as it is proportional on all income over £6500), but is it quite what Adam Smith asked for in the way of certainty for the taxpayer ? A Chancellor may have a good idea of the meaning of those " damned dots " and yet blench at this prospect.

It is not easy in a lecture to deal with the actual form of the curves proposed at different times. There is always a tendency to regard a neat or elegant device as " natural " and therefore fair, and to suppose that we have rescued progression from the charge of arbitrariness. But no one can tell, when all is done, which curve really represents our subjective sacrifice. Even if you decide that a certain burden is fair at £10,000 compared with

[1] *Vide* Professor Edgeworth's article, *E.J.*, June 1919.

one at £200, the paths between those points, and beyond, are legion, and who can say which best reflects the relative feeling of "hurt" or sacrifice at different points in the line? "The heart knoweth its own bitterness, and the stranger intermeddleth not with its joy."

I have elsewhere suggested that it is very difficult for a man to say quantitatively that one boot pinches *three* times as much as the other, even where both are his own, and how much more difficult is it for one man to say that his boot pinches twice as much as another's! Perhaps the person who is best qualified to judge as to whether a given scale *does* achieve equal marginal sacrifice is the man who has, in a brief interval of time, gone from one point thereon to another widely different, by a great change of fortune. Even he may be so overcome by his sudden accession of wealth as to regard but lightly the new burden until he has accustomed himself to the social demands or standard of his new scale of income. As Pascal said: "La coutume est une seconde nature qui détruit la première."[1]

When I was a Surveyor of Taxes I often felt inclined to put up a prominent notice in my office: "Please don't say you would be pleased to pay the tax if you'd only got the income, because you wouldn't."

[1] *Pensées*, I. Art. vi. 19.

CHAPTER III

THE STANDPOINT OF THE INDIVIDUAL IN RELATION TO TAXES ON EXPENDITURE, SPECIAL RECEIPTS, AND SAVINGS

1. *Expenditure as a Test of Ability to Pay*

William Newmarch, to whom these annual lectures stand as a memorial, once remarked in evidence: "The principles of taxation, the system of taxation, ethical and technical, is governed by three leading principles. In the first place, persons must be taxed according to their respective abilities, in the second place, saving or contribution to capital must not be taxed, and in the third place, the law should studiously avoid making the payer his own assessor. The tax on incomes necessarily and inevitably offends more or less against all those principles, and it is therefore a bad tax. Taxation according to ability is to require from all subjects of the State an equality of sacrifice, which for fiscal purposes may be defined to be taxation in proportion to expenditure."[1] In a rather close examination upon his evidence he was asked to explain his view that tea and sugar were "the fairest subjects of taxation

[1] 1861 Comm. Qs. 682 and 694.

because they are articles of largest consumption," and that taxes did not interfere with trade.—" It falls equally upon all, but does it demand equal sacrifices from all ? " to which he replied, " Every man has an opportunity to decide the measure of sacrifice that he will make." When asked whether the sacrifice of a washerwoman on her pound of tea was equal to that of the Duke, he said that " it was no part of the system to readjust the vicissitudes of fortune." Newmarch clearly believed that a tax on tea satisfied all the fundamental conditions of taxation, and especially that of equality. There are many economists, from Newmarch and Mill [1] to Professor Pigou,[2] who think that the exemption of savings or the taxation of income spent is the ideal course. But nearly every one has moved away from the crude views of Newmarch. It is difficult even to suggest that a man who has £300 a year and has to spend it all has the same *ability* to pay as one with £400 who is able to live on £300 per annum, and save £100 plus the interest thereon annually. For in a few years the latter would have amassed several thousands of pounds, when the former is penniless. The fact is of course that there is a conflict of principles, viz. the measurement of taxable ability by income, and the economic necessity for not discouraging the accumulation of capital. The exemption of savings from an income tax comes down logically to an expenditure tax. But we may ask: If a man is so rich that he finds

[1] *Principles*, Book v. chap. iii. (S. 5).
[2] Pigou, *Wealth and Welfare*.

it hard work to spend his money and it accumulates almost without effort on his part, is it any reason why his taxation should be restricted? The question of the relative effects of different kinds of taxes upon accumulation falls to be considered in the fifth lecture, but the exemption of savings can clearly not be justified on the principle of ability alone.

2. *Double Taxation under the Income Tax*

It is urged that our present system amounts to the double taxation of income, a discrimination against the "Savings-use" as compared with the "Spendings-use."[1] If I have £100 (charged to income tax upon its receipt) and decide to spend it on expensive dinners, I have done with it immediately. But if I decide to buy a piano with it, I receive an income of enjoyment (perhaps!) from that instrument for years without molestation by the tax collector. If, however, I put it into railway stock my annual income therefrom—received temporarily in currency notes, it is true, but actually turned immediately into concerts—is greatly diminished. To that extent I am encouraged to spend and not to save. For if the future excess of consumption goods over present consumption goods was just sufficient without a tax to induce me to save, any reduction of that excess by taxation makes me more careless of the future and disinclined to exchange its enjoyment for present enjoyments.

[1] Pigou, *op. cit.*

An alternative method would be of course to exempt the *income* derived from savings, at any rate during the liftetime of the saver, and this might appear to be more logical than exempting the amount of income saved. For at the time it was "incoming" it would rank for the purpose of reckoning ability, but during the spending of its interest or produce annually afterwards it would not. There is a dialectical answer to the claim for exempting savings from taxation which may be put thus: When you consume an income from savings, you consume something larger than you would have consumed if you had spent the original money instead of saving it. This "something more" is the economic reward of "waiting" or compensation for "abstinence." That reward is a kind of income, and there is no reason why the income earned from "waiting" or "abstinence" should not be charged like any other income. You might as well exempt those elements of a large dividend which are the reward of risk-taking. Let us assume that a man saves £100 and at the end of ten years has had £5 per annum, and still having his £100 he then spends it. He pays tax in all upon £150 either under the present system, when his tax is on the £100 at first and the £50 by annual instalments afterwards, or under an alternative system of taxation on expenditure, where he pays on £5 per year for ten years and £100 in the tenth. In either case he pays on £50 more than if he spent the £100 in the first year. It seems to be a misnomer to call this "double taxation." What is really intended by

those who talk of the discrimination *against the "savings-use"* is, I think, on the following lines: Capital accretions are socially of great importance, so much so, that in our taxation system we ought to *discriminate in favour* of the "savings-use" compared with the "spendings-use." The claim is really to *favour* saving rather than to remove a burden on it.[1]

The first difficulty of taxation by reference to expenditure alone is that it does not reach what I have called "special faculty," and a few references must first be made to this, as it comes between the consideration of taxation of income and that of capital.

3. "*Special Ability*" *or* "*Windfall*" *Taxation*

(*a*) *Increment Value Duties.*[2]—It is a normal thing to settle a man's "ability" by looking at his regular income, but if something comes along for him which is over and above his ordinary expectations, and is therefore an "extra" in relation to his normal standard of life—especially if it is un-

[1] [The view taken in the text has not been supported by the majority of economists since it was written, Professor Pigou leading those against, and Professor Cannan those in favour. The issues are too involved to be set out here, but the latest analysis (*Economic Journal*, by C. W. Gillibaud, 1935) is a powerful statement of the conclusion given above, from different angles. My own view as to a general income tax is unchanged, but I consider that high surtaxes may be quite different in effect. If a rich man and a poor man want the same consumable food, they pay the same price and get the same "yield"; if they want the same capital investment, they get a different yield, and the effects of this discrimination on the contributors to the money market for securities cannot be negligible.]

[2] These passages were written before the abolition of the Land Values Duties in the Finance Act of 1920.

expected or undeserved—such a receipt is supposed to possess a peculiarly high degree of "ability." It ranks in that respect quite outside the ordinary tests of income. Popular feeling has hankered after the special taxation of "windfall" items to a remarkable extent of late years, and as a development of modern times one is almost obliged to lay it down as a principle that *irregular or spasmodic receipts which were not required or essential in order to provoke or sustain any economic effort or sacrifice, possess in the abstract a higher degree of "ability to pay" than corresponding amounts of regular income or capital.* Whether this principle can properly form the basis of a practical tax is still a matter of doubt, which the record of recent attempts has not yet set at rest.

The term "windfall" was first actively used in platform rhetoric, in connection with the "Increment Value Duty," and it expressed pretty exactly the popular idea or justification for a special charge. Yet in this particular instance the increment in value to be taxed was frequently not a windfall at all, but an *accumulation of compound interest* on a site that had had to wait for a long time before it ripened into full saleability. That compound interest had not been taxed to income tax during the period over which it accumulated, and so a special duty merely filled up the gap in the income tax scheme which took no account of such an accumulation of unpaid interest.[1] But there were, and are, notorious instances of "jumps" in site

[1] *E.J.*, 1913, p. 204 (S.).

value far exceeding any "interest-on-waiting," and these increments may be considered to have a "special ability" quite apart from the question of the total income of the recipient. In the German scheme the main leading principle was always, of course, that the "tax" was merely a restoration of a part of surplus value which is never *actually* the property of the owner, but which being socially created is socially owned.[1] Nevertheless, the faculty principle, or "ability" to bear a public impost, crops out occasionally. It is generally in the special faculty aspect rather than the ordinary aspect of ability, for it is said, in effect, that a "windfall" is better able than regular income to bear a tax without hardship, whereas the principle of ability in its ordinary aspect makes tax-paying capacity increase progressively with *total* income. This special aspect is particularly present in the arrangements for duty to be paid when the fund for payment actually comes into the payer's hands. But the ordinary aspect is almost absent in both systems, for whether the taxpayer's ordinary income be £1000 per annum, or ten times that sum, he pays the same duty. A small concession to the principle is, however, present in both systems. In Germany all increment arising on sales of property not exceeding £1000 in value (or, if unimproved, not exceeding £250) was exempted if the income of the vendor (and his wife) was not more than £100 a year, and if he did not deal in property as a business.[2] Our system grants exemption on the increment in

[1] *Local Government Review*, Dec. 1912 (S.). [2] *Loc. cit.* (S.).

value of a site of a house resided in by the owner, where the annual value of the house does not exceed £16 in the country, and amounts correspondingly higher for London and large towns. There is also a provision to exempt land occupied and cultivated by the owner where he does not own more than fifty acres, and the average total value does not exceed £75 per acre, provided that it is not occupied with a house worth over £30 rent per annum. Neither system recognises the "faculty" principle sufficiently to grant "set-offs" for decrement against increment, or to complete a partnership between the State and the individual in relation to losses as well as profits. But the German plan provided for a second taxation upon a second and "duplicated" increment. Thus, if a property rises from £1000 to £1500 in value (tax being paid), then falls in value, and again rises to £1500, in Germany, duty would be payable on the second increment, and so on indefinitely, but British duty would never again be paid until the value of £1500 is exceeded. Therefore our system is more impersonal and objective, carrying out more completely the "public-value" principle to the exclusion of the "special-ability" principle.

In regard to the rate of tax, if in nothing else, the British system is simplicity itself, for it takes one-fifth of the increment in excess of ten per cent. But the German law here exhibited the utmost complexity and ingenuity. A few of the "stages" may be quoted by way of example. The tax was

10 per cent if the increment is not over 10 per cent,
11 per cent if the increment is between 10 and 30 per cent,

and the tax increased by 1 per cent for each 20 per cent increase in increment, until 20 per cent was payable where the increment was 190 to 200 per cent, and by 1 per cent then for each 10 per cent increment up to a maximum tax of 30 per cent where the increment exceeded 290 per cent.[1]

(*b*) *Reversion Duties.*—The Reversion Duty was a still clearer example of the "special-ability" principle, but even here the capital value of the property reverting is really a deferred annual payment, which should be added to the ground rent to give the real consideration for the use of the land over the period, and on this payment no income tax has apparently been borne by the owner. The 10 per cent duty may be regarded as equivalent to a deferred tax on these deferred annual payments.[2]

(*c*) *Excess Profits Duties.*—The justification for the Excess Profits Duty was peculiarly the "special-ability" principle.

The pre-war amount of profits was accepted as that to which there was a normal title, and anything above it was "war luck"—"a windfall,"—something which had a special power to afford the tax. As the Chancellor frequently said: "Any business which in these difficult times has more than it had

[1] *Loc. cit.* p. 415 (S.).
[2] *Economic Review,* 1911 (S.); *Incidence of Taxation of Leaseholds.*

in pre-war times, may be reckoned *fortunate*," and it was this good fortune that gave the basis of principle to the tax. But it is not necessarily good fortune to an individual shareholder viewed in the light of his total circumstances. All you can say to the individual is : " I know that your income as a whole has shrunk from £1500 to £1000, and the income tax progression will properly recognise that fact—I am concerned with that particular dividend of £100 which, through no virtue of yours, would be £200 during the war if it was not taxed, and I frankly pick it out for special treatment and take a part of the increase because of its windfall or 'lucky' character. The exigencies of the times are such that I cannot be a partner in your losses and give you a set-off for the dividends that have diminished." This is the only kind of answer that can possibly be given to the individual so far as the old Excess Profits Duty is concerned, apart from the question of practical expediency. We are still left to consider excess profits as they exist apart from war-time, and to ask whether, granted there is " special ability," a windfall or luck receipt, such special ability can be independent of the amount of individual incomes and reside in a corporate or non-personal body.[1]

A theoretic basis for the proportional taxation of the excess profit (unrelated to any standards)—*i.e.* at a flat rate—may perhaps be found in the benefit principle, if it is postulated that the State and the community during war-time supply elements

[1] These paragraphs are reproduced from the *E.J.*, 1917 (S.).

through which excess profits arise, and that such external assistance is unrelated to previous circumstances or to the absolute size of the business. Under this conception, the "tax" element is in the background, and the position emerges that the payment is a *business* expense, a royalty, a condition precedent to the making of profit. It is a payment out of gross profits *before they can become income at all.* If excess arises through increased output at original prices, the communal necessities have provided the conditions under which that supply is taken up, and a charge is made for supplying those conditions; if the excess arises through higher prices on normal output, the State makes a similar charge. Apart from the rare cases where excess is due entirely to reduced expenses, these two classes or a combination of them cover the field, and a proportional charge is, at any rate, comprehensible on this principle. The basis for a progressive charge on the simple excess is not so clear without recourse to some element of faculty. As soon as it is decided to relate the excess to a basis of capital or pre-war profit, before applying a progressive tax, the popular idea, as to special war-time "ability to pay," seems to have a chance to operate.

Each business may be looked upon as a collective entity of "hard assets" with a capital *cost value,* to which there is attached, with its ordinary human association, a normal accretion of products, viz. average interest; then any concern, which by fortunate *Konjunktur* has a much larger normal accretion than others (*i.e.* a real goodwill), has a

greater *capacity* to bear tax thereon without impairment of its present or progressive productive power. Thus by vesting an impersonal faculty in each self-contained aggregation of assets this form of taxation may be reached. But when the second kind of relationship, that which compares the excess with the pre-war profit, prevails, and the tax is progressive accordingly, we seem to get near to the principle that "to him that hath shall be given, and from him that hath not shall be taken away even that which he hath." The potentiality of each group of assets is stereotyped at its pre-war results, which are assumed to be what were right and proper in its particular circumstances. There, is however, little to show how far such basic considerations have really been responsible in the general systems actually in force.

(*d*) *War Wealth Taxation.*—In a similar way the present agitation for the taxation of war fortunes is by reference to the principle of special ability. It is said that at a time when many people found their capital reduced through the war, those who had accretions to it have a special ability attaching to the increase. One man has his capital decreased from £50,000 to £40,000, and another has his increased from £10,000 to £40,000, but under all ordinary taxes they will now get treated alike. But one is an unlucky man, the other is lucky, and a new discrimination may be introduced by a special tax, reflecting this difference in special ability. If the tax is graduated according to the total fortune, either pre-war or present, it follows the ordinary

ability principle and is progressive with total resources. But in so far as it is graduated also according to the amount of the increment during the war, it is based on this special ability. For example, if a war increase of £10,000 upon a pre-war basis of £20,000 bears a rate of 10 per cent and a war increase of £10,000 on a pre-war base of £200,000 bears a rate of 50 per cent, we should bring the scheme under the principle of ordinary ability. But if an increment of £50,000 (whatever the basis) is taxed 20 per cent and an increment of £100,000 (on the same pre-war level) pays 50 per cent, it would be on the principle of *special* ability, on the ground that the windfall is increasing in tax-paying power as it increases in size.[1]

4. "*Special Ability*" *Abroad*

The Australian Commonwealth taxes cash prizes in lotteries on 10 per cent of the gross proceeds, although the rate of tax applicable to the income of the recipient may be quite different, and in Tasmania a further 10 per cent is chargeable. In Western Australia stakes won at horse races are charged—the Turf Club or racing proprietor paying at a flat rate and deducting the duty from the stakes when paid over. On the whole, however, it is rarer for this class of receipt to be chargeable, because it is

[1] Both of these classes of taxation were illustrated in the proposal made before the Committee on War Wealth. [It may interest those to whom that subject is an academic or historical curiosity to know that the proposals came to nothing, because immediately after the Committee reported the great 1921 depression set in and most of the surplus values under discussion vanished in a few months.]

generally considered to involve the corresponding responsibility in the case of losses, and if the principle is carried through there would be no net revenue derived. Such a consideration has been important in regard to the taxation of ordinary speculative gains in stock exchange transactions.[1]

5. *Expenditure Taxes* [2]

Of course taxation of income *not saved* is full of practical difficulties, but it is sometimes thought that the same result can be reached by taxing the things upon which income is spent.

It is clear that failing the possibility of taxation on the whole expenditure we could reach the same goal by putting a tax upon particular items provided that those items figured in every one's expense in exact proportion to the whole expenditure. Thus suppose we wished to tax an expenditure of £300 to an amount of £10 and an expenditure of £600 by £20, and failed to do it by direct means, we might select several articles, for example, beer, sugar, tea and tobacco. If every one spent, say, a fifth of his income in these four articles, we should get £60 spent in the one case and £120 in the other, and a tax amounting to 3s. 4d. in the £ on those articles would bring us the required revenue. But this

[1] It is not strictly necessary for all losses to be allowed. *Vide* Income Tax Report, par. 94, where it is proposed that losses shall be allowed only from profits of a *similar* character.

[2] [While nothing in the text has actually been falsified by later developments, the spread of the " turnover " or " sales tax " has been so rapid and so far-reaching that the whole subject of expenditure taxes must be viewed on a grander scale. A note on this new development is given at the end of this chapter.]

would be *flat or proportional taxation.* Such a system in practice fails to do justice to the principle of ability because if any such articles in general use are chosen, the proportion of income spent on them tends to diminish as incomes increase—a man with £50,000 a year certainly does not spend £10,000 a year in beer, sugar, tea and tobacco. So far, then, from the taxation being *progressive* it is actually *regressive* and badly so.[1] No system of taxation of commodities has yet succeeded in being properly progressive. Then it fails to do justice to personal obligations, and indeed does them an injustice; for the more claims a man has on him through a large family, the greater is the tax to be paid, instead of the less. Again it makes no discrimination between earnings and investment income, for if they are spent alike they are taxed alike. And then, of course, the "special ability" attaching to certain receipts gets no recognition in the form of heavier taxation.

As will be shown in the next lecture, administrative difficulties introduce a second kind of regression. If the article taxed is one in general consumption, not only does the man who has the less real ability by reason of his family obligations tend to consume a larger *quantity* in proportion to his income, and, therefore, to pay a higher tax, but he also pays relatively more because he has an inferior *quality.* Most taxes have in practice to be *specific* and do not vary freely with the sale prices of an article.

[1] [This was fully examined by the Colwyn Committee 1927, whose report should be consulted on all these questions.]

Alcoholic liquors for example are taxed broadly according to their alcoholic content, and the price of the rich man's wine contains a far less tax proportionately than the same sum spent in beer. Although cigars are charged at a higher rate than tobacco or cigarettes, price for price the expensive brands have a far lower percentage of tax.[1] A similar difficulty arises over the better kinds of tea. In countries with extensive tariffs the examples of this regressive taxation, where the burden varies inversely with ability, can be multiplied indefinitely.[2]

If we had a graduated tax on present expenditure, the rich man would be charged at the same rate whether he had inferior or better clothes, or food, or furniture. As it is, any attempt to get a perfect system by taxing the articles themselves leads merely to regressive taxes.

Taxation of residents according to the value of their houses is a tax on expenditure, and a rough kind of income tax, in so far as it is true that the income tends to vary directly as the size of the house. But as I have shown in *British Incomes and Property*, the proportion of income paid in rent gets continuously less as the income gets greater. For the smallest class of incomes 30 per cent has been paid in rent. When we reach £400 to £500 it is about 10 per cent, and at £4000 it is 5 per cent only.[3] Therefore a flat rate of charge on the rental value is really a regressive tax on the income, and when we reflect that the man who has the greatest family

[1] These facts were recognised in the Budget proposals of 1920.

[2] Higginson, *Tariffs at Work*, chap. iii.

[3] *British Incomes*, pp. 454-462.

obligations and therefore the least tax-paying ability, is the largest consumer of this "commodity," it is seen to be a more regressive tax still. Professor Marshall has pronounced in favour of a steeply graduated house duty, for national purposes, in relief of the pure income tax, and not suffering from the defects of the latter or acting as a double tax on savings.[1] He thinks also that there should be a tax on domestic servants and that the house tax is in effect such a tax.[2] His statement that "rich people with small families select well-appointed houses in expensive neighbourhoods, and poorer people with large families go where accommodation is cheap" may be true, but it does not alter the plain statistical facts as to the relation between incomes and rent, and the regressive nature of the duty.

Whatever virtue a tax on rental value may have as a pseudo or presumptive income tax, the local rating system in this country may be said to possess it. I cannot burden these lectures with a discussion of the difficult and well-worn question of the incidence of rates, but it will be sufficient to say that a contribution is secured from the tenant which has a rough relation to his gross income, though not one which squares precisely with modern conceptions of ability. Enough has been said to show that rates are gravely regressive, both from the point of view of total income and also the general family obligations resting upon it.

[1] *After-War Problems*, p. 324.

[2] [The Inhabited House Duty, regarded as a trifling and troublesome form of Income tax, has now been repealed.]

6. *Indirect Taxation in General*

Must we conclude then that indirect taxation of commodities is inherently bad? If it existed by itself it would be very bad, but as a minor part of a general scheme, carefully watched, it can be made to conform roughly to the principle of ability, over an area which, though rightly taxable, cannot be properly reached by direct taxation. Direct taxation of the poorer classes must be in frequent and varying doses if it is to conform to the short period fluctuating ability of those classes, and such a tax is troublesome to assess and to collect. It is frequently alleged to be impossible to *tax* the working-classes, and that any tax which they may appear to pay, either direct or indirect, is actually thrown off, by means of increased wages, on the other classes. For it is said, if they receive only a subsistence wage, its reduction by taxation reduces efficiency, and more wage has to be paid to make up the old standard, and that no permanent encroachment upon a minimum standard is possible. In the last chapter I referred to Mr. Hobson's division of the reward paid into "costs" and "surplus,"[1] and his contention that the taxation of costs cannot in direct theory be achieved.

Mr. Hobson sets out to show:

(1) "That all taxes must be treated as deductions from real income.

(2) "That income is divisible into (*a*) economically necessary payments for the use of factors of production, *i.e.*

[1] Hobson, *Taxation in the New State.*

costs, and (*b*) unnecessary or excessive payments, *i.e.* surplus, and

(3) "That all taxation should be directly laid upon surplus, because, if any taxation is put upon 'costs' the process of shifting it on to surplus first involves waste and damage to production, and is frequently made a source of extortion from consumers; secondly, it deceives the public by concealing the final incidence."

Mr. Hobson elaborates a new kind of "ability" to pay, viz., that power to suffer finally and without affecting production, which surplus, or the non-functional sections of reward,—reward not required or earned in an economic sense,—really possesses. This is an extension of the "windfall" or special faculty principle to which I have already referred, and is quite different in character from what is ordinarily reckoned as ability, dependent on quantitative rather than functional or qualitative tests.[1] The ordinary principle of ability judges upon a *vertical* scale of magnitude incomes that are alike in "quality," but the special principle judges upon a *horizontal* scale of similar magnitude things that differ in quality.

T. Cunningham, a writer in the middle of the eighteenth century, said, "You are forced to bear the Bearer as well as his share of the burden; which will always be the consequence of laying taxes upon workmen, labourers, and servants, or upon any Thing they must necessarily consume; for such taxes only serve to enhance the price of labour and consequently the price of everything thereby pro-

[1] These paragraphs have been taken from the *E.J.*, Dec. 1919 (S.).

duced, which, of course, lessens our exportation and injures every branch of our Trade." [1]

Down to 1750, throwing off taxes by the poor was put forward without argument as obvious, but after that it was more in dispute. "The labourer must live by his wages, and he that employs him by his profits, and if by taxes you increase the necessary expense of both, the former must have higher wages, and the latter greater profits, otherwise the one must starve and the other become bankrupt." From one and the same persons, we get the contrary arguments, that it is cruel to the poor to tax them, and that they cannot really be taxed. There is, of course, some truth in the contention, but it is very materially restricted or modified by two important considerations.

7. *Wages contain, in fact, a Taxable Element*

First, the theory assumes that the whole wage is wisely spent, and that prior to the imposition of the tax every penny is employed in making or keeping up efficiency. But this is manifestly not so. Probably in the spending of *every* wage there is some part that is ineffective and some part that is positively detrimental from the efficiency point of view. If we can succeed in pegging a tax at that point, and reduce the quantity of the commodity obtained, we may in the one case leave efficiency unaffected, and in the second positively increase it. Suppose that a wage of 60s. is commonly spent so

[1] Cunningham, *History of National Debts and Taxes* (1773).

as to include 1 lb. of tea, 4 oz. of tobacco and 14 pints of beer. Let us assume that if the fourth quarter of tea were forgone no harm would ensue, and that if the fourth ounce of tobacco were given up, efficiency would be unaffected, but that the giving up of the last 7 pints of beer left the worker more alert and competent and made the mother attend to the children better, while the remaining quantities of these commodities had certain virtues in maintaining well-being and contentment. Then the imposition of a tax on these commodities, putting up their price so that only these reduced quantities were obtainable with the old outlay, would in two cases have no reaction upon efficiency, and in the other would probably increase it. In short, a wise selection of commodity taxes searches out the non-functional surplus in *spending*, where an income tax cannot.

Of course the wage-earner can insist on having the old quantities of such goods, and make up the difference in his expenditure on essentials like food or boots. But human nature being what it is, the increased dearness of a particular article is more likely to have a definite effect on the consumption of that article than an income tax which would tend to be saved out of *all* the commodities. That is to say, a direct tax on a wage-earner is more likely to reduce expenditure on primary essentials, and so to react on efficiency as to be thrown off on to other classes, than consumption taxes on specific non-essentials.

The second point is that the efficiency *given* by

the direct expenditure of the community may equal or exceed the efficiency *taken* away by the tax. Suppose school feeding were paid for by imposing a sugar tax—the net effect on the health of the family might not be adverse, if the detriment caused by depriving the children of some sugar was more than made good by the benefit from the food provided.

In so far as collective spending is wiser than individual spending, a tax may increase efficiency, and therefore not be thrown off. While so great a proportion, on the average, as one-sixth to one-fifth of a worker's income is spent in beer, it is idle to talk about taxation being thrown off because efficiency is reduced. This could only be the case if the worker insisted on having an unreduced quantity of beer, and the *extra* expenditure thereon, caused by the tax, curtailed other items of the household budget.

The truth is that there are two aspects of "economic costs," viz. what the worker as a producer will not *offer* his work without, and what he cannot go on without; and that in practice, since there is always a margin of wastage in wages inefficiently spent, a wage that in the *net* sum spent efficiently is just a subsistence wage, is actually on the *gross* sum received, but not wholly wisely spent, rather *more* than a subsistence wage. Part of the gross sum received may therefore possess the Hobsonian "ability" after all. Only consumption taxes can possibly tax these personal elements, and obviously they should be placed almost entirely on the non-essentials.

What has been termed the "cynical" principle of taxation, viz. "get your revenue where you can with as little fuss as possible," is responsible in most countries for much financial legislation, which offends against the principle of ability, both from the point of view of regression and "taxable surplus."

8. *The Family as the Unit of Taxation*

It is obvious that consumption taxes must fall upon the *common* purse of the consumers, otherwise people are being taxed who have no incomes. That common purse is usually the wage of the wage-earning father of a family. If this indirect taxation, by commodities, is necessary in order to reach easily, and without too great expense, classes or elements of income which are difficult or expensive to touch by income-tax methods, then it is clear that any income tax system which is correlative to the indirect or commodity taxation should be so framed as to correct its anomalies. If it is to do this, the unit of income taxation must also be the family, and so we find that in most countries with a developed income tax charged upon smaller incomes, there is something analogous to subsistence allowances for the wife and young children.[1] The worst features of the regressive taxation burden upon a family are therefore relieved by the special allowances in the income tax, when the two taxes are added together. In Sir Herbert Samuel's

[1] 1920 Comm.; Appendix 14 (*a* and 14 (*b*).

address on the Taxation of Various Classes of the People,[1] we get the following aggregated figures for taxation paid for a family of four persons in 1918–19:

Income.		
£100.	£13^{16}	or 13·8 per cent paid in taxation (all indirect).
£150.	£16$^{8·1}$	or 10·9 per cent paid in taxation indirect, and 4/6 or ·1 direct, equals 11 per cent.
£200.	£20$^{6·9}$	or 10·1 per cent indirect, and 7/6 or ·2 per cent direct, equals 10·3 per cent.
£500.	£30$^{13·9}$	or 6·1 per cent indirect, and £35 or 7 per cent direct, equals 13·1 per cent.

These figures are for earned incomes, and it will be seen that real progression hardly begins until £500 is reached, for the extraordinary progression in the income tax barely compensates for the regression in the other taxes, when all are taken together. [The comparisons are elaborated in the Colwyn Committee Report (pp. 94-6) for ten levels of income ; the figures for those levels given above are (all earned incomes) :

[1] *Journal of the Royal Statistical Society,* March 1919.

[TABLE

	1918–19				1925–6			
	£	s.	d.		£	s.	d.	
£100.	9	17	6	or 9·9 per cent all earned	11	17	6	nil direct 11·9 indirect
£150.	13	7	0	or ·2 direct, 8·8 per cent indirect =9·0 per cent	17	9	3	nil direct 11·6 indirect
£200.	15	16	6	or ·2 direct 7·7 per cent indirect =7·9 per cent	20	7	9	nil direct 10·2 indirect
£500	50	17	0	or 7·0 direct 3·2 indirect =10·2 per cent	31	2	4	2·0 direct 4·2 indirect =6·2 total

The 1918–19 calculations are different, but teach the same lessons; those for 1925–6 show still more markedly the regressive burden, and only at £1000 level do we find the total burden rising to 11 per cent, as on £100.]

It is thought by some that the incomes of grown-up sons and daughters who live with their parents should be aggregated as a "family income" with appropriate subsistence allowances.[1] But although it is only a question of degree, the extent of their actual contribution to the common purse would often be far more than covered by such allowances, and what they have over and above this contribution they are usually free to spend on themselves. That part is hardly an addition to the *common*

[1] Hartley Withers, *Our Money and the State.* 1920 Comm.; Qs. 6888, 6929, 12,244, 12,261, 12,287, etc., 15,780-882.

tax-paying ability, but is retained by them as individuals. It is not usual for a common responsibility for the living of the mother and the younger children to be assumed by such adults. In this matter, much must depend upon the mode of life in the several countries concerned. Most Continental systems of income taxation make special allowances for dependants, and some even give relief for prolonged illness and other inroads into tax-paying ability.[1] The unit of taxation tends rather towards the household. For example, in Prussia the incomes of husband, wife, and children under age are aggregated, but in this as in most of the systems there is respect paid to the earnings from independent sources, and it cannot be said that there is any general principle logically carried through.

In this country allowances for "children" were a feature of the earliest income taxation, and then they were dropped because of administrative difficulties.[2]

9. *The "Turnover Tax"* [*or Sales Tax*]

The taxation of consumption or expenditure might be carried out by a "turnover" tax on all retailers. But such a tax would enter twice or more times into price when goods are bought for use for business purposes. A man might buy a dozen gas mantles and use six in his house and six in his shop—the latter would be a business expense and enter into price, so that on the sale of his goods,

[1] *For. Income Taxes*, 1913, p. 15. [See also for Germany, p. 201.]

[2] Dowell, iii. p. 103. [These allowances are now a very important feature.]

tax would be paid upon tax. Such a result would be very difficult to avoid. The Mexican system is the best possible example of such a tax, where the duty has been imposed either by larger payments on the sales as a whole or by something similar to our receipt stamp on all smaller sales. As it applies to all sales whether for further manufacture or not, there may be a very considerable enhancement of price on certain classes of goods. If devices were adopted, analogous to drawbacks, in order to make the tax a true flat rate upon all expenditure irrespective of the class of goods or accidents of manufacture, or to give it a true progressive effect, the tax would certainly be unworkable in practice.

Prior to 1853 there was a graduated receipt stamp duty in this country at the following rates :

Amounting to	£5	and not amounting to	£10	—	3d.
,,	£10	,, ,,	£20	—	6d.
,,	£20	,, ,,	£50	—	1s.
,,	£50	,, ,,	£100	—	1s. 6d.
,,	£100	,, ,,	£200	—	2s. 6d.
,,	£200	,, ,,	£300	—	4s.
,,	£300	,, ,,	£500	—	5s.
,,	£500	,, ,,	£1000	—	7s. 6d.
,,	£1000 or upwards				10s.

This duty was repealed in 1853 and the fixed 1d. duty then introduced, the following statement on the subject being made by the Chancellor of the Exchequer (Mr. Gladstone). " We propose next to deal with an article which in its present state is most unsatisfactory, and that is the article of stamps on receipts. This is a duty which does not

grow as it ought with the transactions of the country, a duty which is evaded wholesale, and a duty which, I must say, entails very considerable inconvenience. It is not the mere question of charge that measures the burden and annoyance of a tax, but the necessity of dealing in particular papers stamped with particular amounts, which you have to send and get as occasion requires, with trouble and loss of time—all these are little things, but all of them enter very much into the question of inconvenience and create just objections to the tax." [1]

The French duty of 1914 charged a tax graduated in four stages from 20 centimes on 200 francs to 50 centimes on 3000 francs or over.

The Mexican scale of charge is 1 centavo on 50 centavos to 1 dollar, 2 centavos on 1 dollar to 20 dollars, and 2 centavos for every additional 20 dollars. Although indefinitely *ad valorem*, it could hardly be said to be a progressive tax on income spent, for all the purchases might be in small quantities, though it certainly has progressive tendencies. It fails to reflect any of the other aspects of ability.

[Although the Sales Tax was known over a quarter of a century ago, as in the Mexican example given above, it has a much more respectably ancient origin. A turnover tax of one-half per cent existed in the time of Augustus and it has a long history in Spain (as the alcabala), where it is even credited with having been the cause of the ruin of manufacturers and the downfall of Spain. In England,

[1] Dowell, iii. p. 300.

the campaign for it in recent years was fitful and not strongly supported. I have opposed it as being "regressive" on the individual, for the expenditure of the poor man is charged at the same percentage as that of the rich. In this it is like commodity taxes such as tea and sugar, or even tobacco and beer (but these taxes are avoidable, even if they cannot be evaded!); but if it covers the whole field of expenditure, it is certainly proportional and probably regressive, supposing the richer man to have a margin for saving. There is room for argument, however, that some saving even by the rich involves expenditure on capital goods which will be subject either to the tax or to its influence. Attempts to avoid the worst effects lead to *luxury* taxes by the elimination of necessities, or even by differential rates of sales taxes against better class goods. They also lead to taxes limited to the final products for consumption—an attempt which in a complex community cannot be successful. A shopkeeper buys a set of chairs, using some in his house (as a private consumer) and some in his shop (a business expense)—the Sales Tax must be paid on all without discrimination.

In a country where industry and distribution are complex, we find article A sold by one concern, entering into B, sold by another, entering into C by a third, and C into D by a fourth—each may be capable of utilisation as a consumer's "good," so each must be subject to tax, and by the time D is sold to the consuming customer, the product has paid on the original value of A four times. Now

an integrated business on a large scale performs all these stages of production within itself, paying nothing on them internally, and when it comes to sell to its customer with one final tax, it can easily undercut the prices of the fourth seller in the separate chain, and this leads into the encouragement of mammoth consolidated business against small individual businesses. This is a matter for consideration on its social effects. Again, the difficulties of assessing a low tax on small purchasers, and of computing the liability of hawkers and thousands of small shopkeepers are administrative drawbacks, while the effects upon foreign competition in the home market are important. Having serious shortcomings from the standpoint of the individual, the State, and the community, it is not surprising that the tax has been regarded in England as an expedient for the countries with less advanced ideas, or with simple economic conditions, or inability to face adult responsibilities in individual taxation. The Colwyn Committee in 1926 disposed of it in one paragraph for several of the above reasons, differentiating Britain from foreign countries as having "economic and other conditions very unfavourable to it." But necessity is the paradise of the second-rate. Shoup notes that the Sales Tax has been adopted by none of the European countries which remained neutral in the Great War, and by all the belligerents except Britain! It is important to record that the most striking general development in taxation in the period 1920 to 1935 is the spread of "Sales Taxes" or "turnover taxes"—the

appearance of permanence they have quickly assumed. "In the history of public finance no other tax, save perhaps the one on gasoline, has spread so swiftly over the world. By 1933 some thirty nations had adopted them and abandonments have been rare" (Shoup). The taxes take various forms. In France the *impôt sur le chiffre d'affaires* covers not only sales but commissions, fees, interest and other commercial payments now at 2 per cent *ad valorem*, and it was introduced in 1920 at 1·1 per cent to raise money quickly and easily, and has persisted, despite many attacks, since. Various commodities, meat, tea, etc., have been taken out of it to be subject to special excess taxes. Exact sales records need not be kept by the large majority, nor is any inspection of books and papers required. The tax is based on estimates, with external signs. The tax has thus nothing to do with profit and not much to do with gross receipts. It has shown the various drawbacks mentioned in the text, and gives advantages to large and integrated business units, as well as causing large changes in methods of business. It is admittedly highly regressive and gives ground for high rates of luxury taxes (*vide* Shoup, *The Sales Tax in France, 1930*). Having regard to French mentality towards direct taxation, it is perhaps not surprising to find acquiescence in this tax with its drawbacks. But it was more unexpected to find a great development in the United States. At the beginning of the depression, the end of 1929, it was trivial as a factor in the system of the country, but

by 1934 it had become important in upwards of fourteen States, and was still spreading. The literature of the subject is growing fast—Carl Shoup has a volume of over 800 pages, published in 1934, and fast getting out of date. Whereas in most countries the tax is "general," in the States it is frequently confined to purely retail sales for fear of driving manufacturing and wholesale business into neighbouring States, and because of the constitutional difficulties about taxing inter-State commerce. Shoup considers the cause of the spread of the tax is the decline of the yield of the personal income tax in the depression, or transfer of proceeds to localities. The State property taxes were heavily hit by reduced valuations, and a disinclination to continue to pay on higher values is widespread. But more dynamic was the development of expenditure for unemployment and schools, compelling new sources of revenue. In North Carolina, school policy and the Sales Tax seem definitely related. But protests are vocal on all hands and my own experience, in having to discover an inconvenient loose two cents with a convenient dollar purchase, is typical of a feeling of petty annoyance.

My feeling was, "Why can't I compound once a month for this petty annoyance!" The retailers have often stood virtually alone in their opposition, but have exhibited a surprising degree of mobilisability into a frenzy of activity, generally fruitless. The practice of charging as a separate item frequently breaks down, and the opposition of consumers will stand only so long as they are kept

"tax-conscious" by a distinct charge. The difficulty about sales at retail and for resale is administratively troublesome. "Shifting" is not left to economic forces, and mandatory provisions to get the tax on to consumers are often insisted upon. There are three kinds of plan: (*a*) a schedule or scale agreed upon, in which the tax is added in steps, and tiny fractions avoided—the consumer pays an approximation, more or less, to his true liability; (*b*) with a 3 per cent tax, a 10 per cent article is sold for 11 cents, and the purchaser gets a coupon or tablet, good for seven-tenths of a cent in later purchases; (*c*) books of small value coupons are sold to consumers, who use them as small change—a very unpopular device. Most retailers protest that they are not really shifting the tax. The experiments of the different States differ widely and almost every issue raised in taxation finds some example in their wide variety. In practice the incentive to industrial integration may be avoided by manufacturers' sales taxes at low rates, or purely retail systems. In Austria the total tax rate progresses with the number of taxable "processes." In Belgium and Italy all sales *except* the retail are charged, and this avoids administrative troubles with numerous small retailers. It may be said in general that the characteristic defects of the tax worked out in theory twenty years ago have all been justified by experience, and few surprises have emerged. The best authorities for advanced communities still look on it as second-rate—only justified in emergencies, and consider that its

regressive features ought to be counterbalanced by progressive direct taxes wherever possible.]

10. *Taxation of Capital*

We have now passed from the taxation of incoming wealth with its alleged drawback that it discriminates against saving, to the taxation of consumed wealth, and found that the latter leaves much to be desired, and cannot fully discharge the true obligations of a complete tax. We are brought then to the taxation of unconsumed wealth or "capital," in the ordinary sense.

The taxation of capital may be carried out in various ways. It may occur in an irregular way in the course of taxation of income, where income is so defined as not to exclude every capital element. If no exemptions exist in the income tax for a wasting asset, like a leasehold, we have taxation of capital mixed up with taxation of pure income, and this may generally be justified if the receipts are being *used* as though they were income.[1] The practice as regards such allowances in the income tax is varied, and the evidence before the Royal Commission on the Income Tax has shown that the question is an extremely difficult one. I would refer those especially interested to the evidence.[2]

The next type of capital taxation is regular annual taxation, and here obviously the tax has to be small enough to be paid out of the annual

[1] Vide *Edinburgh Review*, Oct. 1919 (S.).
[2] 1920 Comm., Q. 9883 *et seq.*, Q. 9589 *et seq.*

income. It may be the sole representation of the principle of ability where no income tax exists by its side, as in the case of the general property tax in the United States of America until 1913. It was almost the only tax for long periods in various countries. As such it lends itself very ill to the finer tests of ability that we have set out, for it is not progressive, it rarely includes all kinds of wealth, it rarely makes allowance for family conditions.

The actual ascertainment of income may be, and often is, more difficult than that of property values. In a farming or planting community few people could reckon up their annual incomes with accuracy. Part of the income is in kind, part of it is derived from sales which are subject to deduction for various expenses. To tax in such a community on a basis of income would lead to endless confusion and evasion. To tax on the basis of property is simple, and comes to very much the same result in the end as would be reached by a rigorous tax on incomes.

In a complex community of modern times, however, such as all European countries and most of the United States have come to be, the general property tax proves hopelessly impracticable. It leads to glaring inconsistencies and inequities, and fails completely to attain its professed object.

Every man should pay according to his ability, and ability must be tested separately by reference to the amount, character, permanence, and obligations of his wealth and resources. It is interesting to consider the various capital taxes, such as Estate

Duties, from the point of view of their " responsiveness " under each head.[1]

When the wealth measured is *income* it need not be pure economic *income* but should be what is, by general standards and habits, treated as spendable income, and measured over such periods of time as to give fairly stable results.

[The chief difference of view in income taxation between the United States and ourselves, shows itself in the attitude towards the inclusion of capital gains as income. It is perhaps natural in a country that is continually rising in capital values, and habitually realising them, and where capital accretions in real property and in stocks and shares are an everyday occurrence, touching " ability to live," that such gains shall be equally considered in " ability to pay." But the underlying presumption is one of continual advance, and in this country we have considered the game to be hardly worth the candle, for, the revenue of the country being more static, in the long run losses would tend to offset gains. In any case, the losses would tend to emerge to the full, and the gains tend to await discovery! It is inherent in our view that if gains are charged, losses must be allowed too, and this was the characteristic of the early American practice. But with severe recession in trade, the revenue receipts began to suffer unduly, so that the allowance for losses began to be restricted, and this restriction came down to the allowance of only 12½ per cent.

[1] For a more detailed consideration, vide *Edinburgh Review*, Oct. 1919 (S.).

The history of these provisions in statute and case law and in practice is very complicated and chequered, and as a result of the long depression of 1929–35 there are many who would abandon the system altogether. The National Bureau of Economic Research (Bulletin 55) said, " In the aggregate the drain in the form of losses and dividends for the period 1930–33 exceeded the corporate savings of the entire post-war decade."

It leads to " arranged " sales in order to effect losses eligible for deduction in computing taxes. A has a stock which cost him $10,000 and is now valued at $6000, and B has another of similar character. By selling to each other (or to others in a circle) each is left in the same effective capital position, but has " realised " a loss on sale, ranking as deductible for taxation. Again, when values of shares are rising the knowledge that " holding on " involves no liability, but that selling will create liability, keeps many off the market, and values of stocks continue to rise even higher. Much of the extreme sensitiveness of the stock markets has been attributed to this position of tax liability. I have known many Americans whose policy is to hold on until the margin of profit is so large as to give a certain net position after taxation, and when buying to be willing to give high prices because of the tax relief. The best American opinion has now come to the conclusion that the taxation of capital gains is a mistake. Germany had an experiment from 1920 to 1925 and now confines the charge to speculative profits.]

11. *The Possession of Capital, as affecting " Ability to pay " in Incomes*

One aspect of ability comes out most clearly in reply to the question: Does your income depend upon your personal effort for its continuance? Does it stop when you stop? Upon this is based the discrimination between " earned " and " unearned " income, which is so well known and understood that I need hardly spend much time upon it. It is, however, necessary to clear up some misunderstandings that gather round it, which arise through confusion in terms. There is an idea that the distinction is made for some reasons of social *worth* in the income itself or because it is more honourable to work than to sit still and receive out of the labour of others, or because there is something not quite so righteous about " lazy " income. Without supporting in any way the special position of a rentier class, or the accumulation of capital in the hands of idle people, I feel I can characterise such a view of the difference between wages and interest as economic priggishness. If I get £10 for refraining from consuming and as the reward of " waiting " or " abstinence," I do not rank it on any lower plane than £10 I get from toil—it is just as much a reward for services rendered. The terms chosen are very unfortunate from that standpoint and have led to much confusion of thought and unnecessary rancour. You have only to examine the reasons upon which the distinction is based to find that " earning " or " not earning " have nothing to do with the case

at all. The question of *desert* does not really arise. The true question is: Does this *class* of income entail any special class of expenses in general, and without reference to the circumstances of the particular person to whom it may go? The question "What have you got to do with it?" is the personal one which involves the domestic allowances.

The reasons for giving favoured treatment in this country were almost entirely because certain obligations attach to one class of income from which the other class is free, obligations which reduce its effective amount for the purpose of present clear tax-paying ability. If the Committee of 1906, instead of applying a 9d. rate in place of the 1s. rate to this kind of income, had said any such income should be reduced to 75 per cent of its grosss amount to get its effective tax-paying amount, and then charged upon like terms with other income, the distinction would have been quite clear to all. The Committee fished about amongst the terms "permanent" and "precarious," "investment" and "personal effort," "industrial" and "spontaneous," but were frankly trying to find a term clear of elements of investment and return upon capital.[1] The connotation of the word "unearned" as used in the phrase "unearned increment" has been quite wrongly lifted for its use here. It is the presence or absence of capital resources that warrants the whole distinction for taxation purposes. It was long ago recognised that £100 from toil was "weaker" than £100 from

[1] 1906 Comm. Report, para. 18 *et seq.*

dividends, because the toiler has to make provision for precariousness of employment, sickness, old age, and other infirmities, and also because he is *tied* and often has to incur extra expenditure through living near his work and being unable to select his abode very widely. In this connection it must not be forgotten that we do not get our season-ticket expense between house and business, or the extra cost of our meals in town, allowed as deductions from income.

I ought here to refer to the confused meanings that have come into these terms, though I have dealt with the subject at much greater length elsewhere.[1] The first use is the Revenue use which I have explained. The second use of the terms "earned" and "unearned" gives them a *subjective and qualitative* connotation, for they are made to convey moral and ethical implications, and to express relation to some subjective standards of quality. No one can read the propagandist literature from the time of Mill through the "single-tax" periods down to the 1910 land campaign without realising that these implications were allowed to creep in and occupy a disproportionate part in argument. Their appeal to primitive passions was an effective finish to political harangue.

[1] Some paragraphs here are taken from the *E.J.*, June 1915 (S.). The Royal Commission of 1920 have, for such reasons as those here set out, recommended the substitution of the term "investment income" for "unearned"; and also the abolition of different rates of tax, and the adoption of the method of reducing earned income by a constant proportion to obtain assessable income. In this way there is no longer a suggestion of any difference in *quality*, but rather one of *quantity*, and the allowance of a definite amount to represent the general social expenses to which such income is ordinarily subject.

So the landlord, after being convicted of receiving something for nothing (in the way of action of function), may be shown to live the life of a wastrel, "battening" on the labour of others, consciously hard and unrelenting. Doubtless, too, the fact of large aggregations of "unearned wealth" in the hands of single individuals has an ethical, as well as an economic, import, that has been increasingly realised in late years. One need not look far, therefore, to find reasons for the new elements of meaning that these words have gained. They have been completely given over to, and filled up by, this sense in Lord Hugh Cecil's exposition of political theory, "Conservatism," in his chapter on Property and Taxation.

He furnishes the word "unearned" with a complete and special ethical connotation of his own, which is thereupon postulated as the general connotation and as the basis of the modern taxing idea. He has then little difficulty in showing that this "unearned" aspect of wealth is quite fallacious as a canon for taxation, and by sweeping it away he comes to the conclusion of his argument in triumph. It is not too much to say that he ignores both the general revenue significance of the term already dealt with, and also the special economic sense to which reference will be made hereafter. After dealing with the necessary limitations on absolute ownership, he says: "The conception which lies more or less definitely in people's minds, that a man is justly entitled to what he owns because he has deserved to acquire it, is, I suggest, a delusion;



and all consequent distinctions about earned or unearned increment of wealth are equally unfounded."

After a space he goes on: "Let us say, then, that a man gets wealth by lending his possessions or lending his exertions. A distinction may fairly be drawn between the two forms of lending, and the word 'earning' may be properly applied to the second method of acquisition. But, if so, 'earning' must not be understood to connote any element of desert; for a moment's consideration is sufficient to show that exertions are not paid for in proportion to their desert." Here he compares the easy gains of popular or vicious writing with the niggardly profits of good scientific work, and refers to the fact that a barrister and a ploughman, a prima donna and a labourer, do not necessarily differ in *desert*. He continues: "The whole process is non-ethical, and upon whatever ground the owner can claim a right to his gain it cannot be on the ground that he deserves it." After dealing at some length with the nature and causes of "increment," he says:

"It seems, therefore, evident that the claim of the people, either as users or as an organised community, to appropriate either all the value of land or any particular increment in that value because they have created it and are therefore entitled to a share of it different from what they can fairly claim in respect to anything else, is a pure delusion. But if it be once realised that the forces that make wealth are never ethical, and that the gains made by

lending any possession . . . are equally unearned, and that even gains that depend upon exertion do not correspond to desert, the whole conception expressed in the phrase 'unearned increment' is cut up by the roots. All property is seen to be on the same moral level, as something acquired without injustice, that is to say, without fraud or violence, but not meritoriously so that the owner's title may rest on his virtues."

All this is most true, and it would also be relevant if the taxing distinction in question had ever been based on moral issues. It is, however, quite certain that our present tax authorities afford no favours on the basis of desert; illegal gains can be charged to income tax,[1] and there is no doubt that a professional burglar in making a return for assessment could claim the lower rate on "earned income."

The third connotation of unearned is economic and functional, and was introduced by Mr. Hobson. In his words [2] there is a "fundamental distinction between costs and surplus. Costs, or the payments necessary to evoke and maintain the use of the existing power of production, represent the permanent harmony between capital, labour, and ability. . . . The surplus passes in innumerable fragments to the owners of a scarce factor of production, wherever it is found. . . ." But the surplus is divisible into two parts. The "productive surplus," coming as a rise of interest, profit, or

[1] See judicial dicta in Partridge *v.* Mallandaine, 18 *Q.B.E.* 276.

[2] *The Industrial System*, p. vii.

wages, causes growth in the industrial structure by bringing into productive use more or better capital, labour, or ability. It is necessary to the progress of society. But the unproductive surplus arises where scarcity "enables" a factor to extort a price for its use which is not effective for stimulating supply"—it includes "the whole economic rent of land and such payments to capital, ability, and labour . . . as do not tend to evoke a fuller or a better productivity."

It will be obvious that this distinction is very different from the others. Interest is "unearned" in the Revenue sense, but in the Hobsonian sense only excess interest beyond the minimum for use of capital *plus* compensation for risk, etc., is "unearned." Similarly, all the profits of a private business or from professional services are "earned" in the Revenue sense, whereas in the other view parts of the profits may be "unnecessary" to make the business or professional man work just as well and just as hard, and those parts are therefore "unearned."

Moreover, particularly in regard to interest, the "unproductive" part is not a constant for all individuals—it is essentially a psychological and personal question. The whole fund of saved capital is the resultant of many different forces, and the effect of lowering the rate of interest may diminish the tendency to save with some, increase it with others, or leave it unaffected. Even a four per cent rate contains an unproductive non-functional surplus for some individuals, and a ten per cent rate

may be wholly productive and functional for others. As Mr. Hobson says:

"This objectively conceived surplus is supplemented by a subjective 'surplus' consisting of the differential 'surpluses' of certain owners of producing power who do not require the payment of the normal minimum price as an inducement to evoke the industrial use of the particular power which they own."

He is followed by Professor Hobhouse, who says that "policy is on the right lines in beginning the discrimination of earned from unearned income. The distinction is misconceived only so far as income derived from capital or land may represent the savings of the individual and not his inheritance.... If Liberal policy has committed itself not only to the discrimination of earned and unearned incomes, but also to a super-tax on large incomes, the ground principle, I take it to be, is a respectful doubt whether any single individual is worth to society by any means as much as some individuals obtain . . . the principle of the super-tax is based on the conception that when we come to an income of some £5000 a year we approach the limit of the industrial value of the individual. . . . The true function of taxation is to secure to society the element in wealth that is of social origin."[1]

Mr. W. H. Mallock, like many others, quarrels with the idea involved through not getting beyond the terms used, when he regards the income received

[1] *Liberalism.*

from investments made out of money saved from "earnings," as "earned."

I have brought this section under the present lecture, although at first sight it might appear to be related to the taxation of capital, because in most countries the discrimination is not achieved by taxing income in two different ways, but by having alongside a common income rate a special or extra regular tax on capital values.[1]

[1] These are summarised in the *Edinburgh Review*, October 1919 (S.).

CHAPTER IV

THE STANDPOINT OF THE STATE

1. *The State has an Independent Standpoint*

WE have been so far discussing the individual point of view—the kind of considerations that will occur to Smith and Jones when they are weighing their respective burdens and criticising the distribution of taxation between them. It is important, of course, that any Finance Minister should give full consideration to the feelings of the taxpayers, but he has also certain little preoccupations of his own which do not greatly concern the taxpayer as an individual payer. The legislature imposing taxation has to give particular attention to aspects of the matter which are more lightly passed over by the individual, except so far as he may be thinking politically and as a voter interested in the national finances.

The State as a tax-gatherer has to ask and answer the following questions:

1. Is the proposed tax economical, or will it cost an unwarrantable amount to get it in?

2. Is it within the powers of the administration for assessment and collection, or is it too full of

difficulties to be workable? Allied thereto is the question:

3. Will it be specially open to evasion and provoke dishonesty?

4. Will the imposition of the tax tend to dry up the source of the tax, and so prove abortive for the Revenue?

5. Does it raise political difficulties at home and provoke unrest?

6. Does it raise international difficulties or provoke conflict with other taxing jurisdictions?

2. *The "Economy" of the Tax*

If the initial outlay for establishing the machinery for collecting a tax were so costly that the periodical yield of duty hardly paid a reasonable rate of interest on that outlay we should regard the tax as uneconomical in the highest sense. Such cases are rare, but it is a charge frequently brought against the increment value duties that the original valuation upon which the whole measurement of the duty depends has been so costly that a commercial yield of interest and a sinking fund to get rid of that outlay have not been obtained from the duty, and will not in future be obtained, so that there is no net yield of revenue. While such extreme cases are unusual, it is not difficult to find in the past many taxes which have had very little margin over and above the expenses of current collection. This feature is naturally most obvious with indirect taxes and tariffs. In backward or

badly developed countries, where the administration over a wide area is weak, such as Persia or Turkey, the farming of taxes has not been uncommon, and it is peculiarly wasteful. From a recent account of China we learn the following : [1]

The basis of taxation is a State claim to a share in the produce of the soil. The rent was actually fixed in 1712, and this still theoretically governs the whole of the Land Tax Assessment for China, but in practice various surcharges are put on which, on a most moderate estimate, treble the cost to the taxpayer without adding to the amount which reaches the Central Government. The tax is, in fact, farmed, only the surplus being remitted to Peking, after the expenses of professional administration in the widest sense of the word have been deducted as a first charge.

Mr. Jamieson in 1905 estimated the total Land Tax leviable at 375,000,000 taels, whereas the collection, as regards the surplus reaching Peking, was only 26,000,000 taels, while the actual collection from the public was almost certainly not less than 102,000,000 taels. Sir Robert Hart has estimated the collection as high as 400,000,000 taels.

The next Chinese tax is Likin, a kind of octroi, or a tax on goods in transit. Although repugnant to the commercial Treaties, the tax has been condoned, especially by being accepted as security for foreign loans. This, together with the other miscellaneous taxes of the Chinese system, forms part of the fiscal scheme which has been denounced as " rotten to the core, childish and incompetent."

The immense crop of taxes that followed upon the Napoleonic wars, with a tariff in this country on 1150 articles, included many that were quite unproductive and others that were very wasteful.[2]

[1] *Edinburgh Review*, October 1919.
[2] Armitage Smith, *Principles*, p. 81.

3. *Practicability*

The first argument that is brought against every new proposal departing from conventional lines is nearly always that it is "impracticable." No one alleges that it is impracticable to raise the rate of income tax, estate duty, or tea duty, but if some one proposes graduation or differentiation there must be an inquiry as to whether it is *practicable.*[1] Can it be worked ? This question follows directly upon proposals for preferential tariffs with drawbacks, tariffs with *ad valorem* charges, luxury taxes, turnover taxes, capital levies, levies on war wealth, graduated taxes on business profits, and so on. Many a proposal that is clear and equitable in theory is beyond administrative ingenuity to work. Many thought that differentiation between earned and unearned income could not be worked, but certain difficulties were got over by what was frankly a compromise or concession. The crucial case was the business worked by its owner, when it had to be decided how much of the profit was interest on capital and how much was earnings. The difficulty was met by calling it all "earned." The rest of the field of administration was compassable, and lent itself to regular rules easily applicable.

The crucial case for the Capital Levy in the valuation is the trust and life interest; and in the collection, the reversion and the personal business. The difficulties of the luxury tax lie in a classifica-

[1] 1906 Comm. Report.

tion which shall have regard to the wide range of articles of one type from the poor and essential to the luxurious and non-essential, and also to the fact that superior quality is not necessarily the sign of luxury, but may be real economy and yet fail upon a test of mere price.

A crucial case for the taxation of "war" fortunes arises when a comparison of valuations shows a chargeable increase, but the assets are unchanged and are still giving the same, or approximately the same, real services to the owner. Such a case would be the ownership of a number of properties, with no increase of *net* rent, and therefore yielding an income which, while not greater than before in nominal amount, is actually far less in purchasing power. The capital valuation in such a case upon present scarcity values might well show a very marked increase.[1]

The difficulty in the case of a graduated tax on business profits is a satisfactory criterion of capital employed in the case of businesses which have a goodwill superimposed on the original money put in and so firmly established that it may almost be said to have solidified into a hard asset. Is such additional capital to be ignored?

The land value duties have been a good example of practicability endangered and wrecked by the complexities of the law of real property.

It will be found generally that if a tax is believed to be practicable over a considerable part of the

[1] *Vide* the Evidence before the Select Committee upon the Taxation of War Wealth.

field to which it is to be applied, and the impracticability is confined to a minor part, most States will embark upon the scheme, and by a sacrifice of logical principle at the point of difficulty and the adoption of a few conventions, will satisfy the equities roughly. This is generally possible if it is so arranged that the State rather than the taxpayer is the loser by it. Do we decline to have an income tax because the farmer finds it impossible to say what his income is? No, but we invent an income for the farmer—giving him the option to pay on less if he can show cause, but in no case charging him more. Do we refuse differentiation because the business man cannot say exactly how much of his profit is interest on his capital and how much is the remuneration of his own work? No, we agree to treat it all as "earnings,"[1] [although of course, the allowance in respect of it is strictly limited. In the Colwyn Report, 1927, will be found a discussion of the practicability of the taxation of estates on the attractive "Rignano" principle which would increase the levy upon a particular block of wealth each time it passes, so that it is lightly taxed as the actual accumulators die off, but heavily taxed or wiped out in a later generation.]

In Prussia the taxation of companies on their profits is not strictly compatible with the personal income tax on total income, for while the former diminishes all incomes alike, some incomes should be chargeable at low and some at higher rates. The exemption—so far as the companies are con-

[1] 1906 Comm. Report, para. 19. *Economic Review*, 1909, p. 412 (S.).

cerned—of the first $3\frac{1}{2}$ per cent of the dividends paid by them, is a recognition of the elements of double taxation although carried out in an illogical manner.[1]

In India the considerable administrative difficulties of an *ad valorem* tariff are got over by adopting conventional values for the various commodities where those difficulties are greatest.

4. *Practicability—Tariff Practice*

The tendency of classification in tariffs is, of course, to become increasingly minute and specialised owing to the highly diversified character of modern manufacture and industry. If tariffs proceed by broad groups, then we find that in any one group there are articles the nature and value of which show wide variations. If the duties are specific, then, of course, the cheaper varieties are taxed at a higher rate in proportion to their value. Such a greater specialisation tends to greater conformity with the equitable principle from the point of view of the individual, but from the point of view of the State it adds very much to the difficulties of administration. Where the duty is an *ad valorem* one, the duty charged varies directly with the value of the imports, and so the incidence is the same for cheap goods and dear goods. If you can ensure a highly skilled and pure administration, then the principles of taxation can be closely approxi-

[1] *For. Income Taxes*, 1913, p. 18.

mated to, and all annoyances of further detailed classifications can be avoided.

I suppose the discussion as to the relative merits of the systems is far from being concluded, and the introduction of specific tariffs no doubt does mean a greater interference with the relative demands for the principal classes of goods than business men generally will care to face. On the other hand, the *ad valorem* system is a probable encouragement to all kinds of commercial ingenuity, and to a general lowering of the commercial morale.

In the United States the administrative problem has been boldly and on the whole sensibly handled. Not only do we find a highly specialised system of appraisers, but also the demand for declaration by importers, consignees, and agents for manufacturers.

Mr. Higginson tells us that attempts to put the responsibility of the values upon minor officials, who do not really know the facts, are widespread. Moreover, in smaller countries where specialisation in valuation is limited, and it can be retained in a few hands, the *ad valorem* system can be properly worked. In India conventional values are adopted, but, while they may with a light rate of duty get over many difficulties, they do not respond to variations in trade.

Considering the interests of the State as we find it now, specific duties are probably the best, despite the great difficulty of subdividing the tariff and forecasting the effect of the duties on different grades.

Mr. Higginson has remarked that the duty of 7s. per pound upon imported cigars in England makes the smoker of a 3d. cigar contribute to the national revenue a far greater amount in proportion to his needs (*i.e.* his expenditure) than the purchaser of a genuine Havana. In this sense, therefore, we have a tax opposed to the principle of ability and of a regressive order. He says that while the democratic interests of America favour the freer and more elastic *ad valorem* duties, the German mind has naturally tended to consider the power of the administration.[1]

When we come to consider the questions which arise as a general result of a tariff, practicability is again important. For example, drawbacks are very easily devised in theory, but they are extraordinarily difficult to secure administratively against fraud. There is probably at the present day no really satisfactory and sure method of securing the State against abuse. Recent experience of an analogous kind in connection with the motor spirit duty will be in point here.

Canada has experience of an intermediate tariff which has been used as a means of bargaining for favourable treatment of home products abroad. Such a scheme seems to be free from some of the objections of the maximum and minimum tariff.

The practical administration of a preferential tariff is, however, full of radical difficulties, similar in character to those found in connection with the

[1] Higginson, *Tariffs at Work*, which should be consulted on the whole subject. These anomalies were remedied to some extent in the Finance Act of 1920.

ad valorem duties and the under-valuation of goods. These are got over in practice very largely by a wide interpretation of the rules as to the extent to which British labour is represented in the imports.

[Modern developments of quotas and clearings have greatly advanced the technique under discussion and the subject is too vast to be developed as a mere illustration.]

5. *Practicability dependent upon the Powers exercised by the Administration*

It is of course always difficult to say in advance whether a tax will be found to be workable or not, and "workability" itself is a question of degree. Moreover, what is found practicable in one country may easily fail in another, and a country must choose the system which is within its administrative ability. The conditions are perhaps fourfold :

(*a*) Geographical.
(*b*) Political.
(*c*) Strength of administration.
(*d*) Character of people.

In a country with very wide-reaching spaces like Brazil, geography is against it being economical in a practical sense to have an elaborate internal organisation for tax administration. It is quite natural to take the simple course of collecting revenue at a few ports easily within the range of the Government's officials.[1] If a country is dead set against

[1] Cp. *After-War Problems*, Professor Marshall's chapter on "Taxation."

an impost on political grounds, a scheme that is otherwise workable may be made wellnigh impossible. For example, probably no tax could succeed against the organised and carefully advised opposition at every stage of law that has met the Land Values Duties. Certainly, German success in working a system in some respects less justly framed and more complicated cannot be explained merely upon the differences between the two countries as regards the intricacies of land tenure. A " war wealth " levy in this country would be unworkable if it met with *organised* opposition, for so much depends upon the goodwill of the taxpayer. A measure of goodwill alone made the Excess Profits Duty possible.

" Strength of administration " can be illustrated in many ways by comparison between an organised and stable civil service and the American system in force until recent years, which gave little room for the development of scientific methods. The last-mentioned condition, " Character of the people," may be illustrated by what the Germans would put up with in the way of browbeating and inquisitorial action by their officials. The German people were able long ago to enjoy all the advantages of a highly flexible, smoothly graduated tax upon income assessed in a single sum because they paid the price, and that price consisted in being subjected to a fire of highly personal questions in which the taxpayer had to account for every action and expose his motives to the full official scrutiny.

The police system played no small part in the success of the Prussian taxation. But something is said to have been attributable to the development of a "public conscience"—a contention we might have been more inclined to accept five years ago than we are now!

Of course a tax may be so inherently difficult that, outside these conditions, it would be unworkable anywhere. It seems possible, in the light of French experience, that the luxury tax is in this class. Certainly highly elaborated tariffs frequently present awkward features. But some countries are content with a degree of success that would never be tolerated in others, so that questions of practicability are relative.

6. *Fraud and Evasion*

The most important feature of practicability relates to the prevention of fraud and evasion. Is it possible, with a given tax, to prevent undue evasion without framing such rules and regulations as will make life a burden to the ordinary honest man? The State has to postulate that there will be a considerable number of people ready to take advantage of any laxity or any loophole, and it is therefore necessary to see whether an administrative scheme can be devised which is not oppressive but which at the same time will discourage fraud and also expose it. It used to be urged that the income tax was bad because, in Gladstone's words, it made a "nation of liars," and that the best type

of tax was one which did not make a man his own assessor, and therefore did not lead him into temptation.

The smaller types of fraud, trifling omissions from tax returns, petty smuggling, understatements of values, etc., are perhaps, like travelling in a carriage with a ticket of a different class, or passing a child on the railway not strictly in accordance with its age—acts which accord with a somewhat low code of morals in this regard, rather than transgressions against a higher code. The conscience in relation to general or intangible bodies is sensibly lower than in regard to personal real people we know—the revenue and the railway are "fair game." The State is very intangible to the average man.

Just as a schoolboy who would not think of robbing his mate of a top will gladly raid an orchard, as a matter which is on a quite different plane, so Smith, who does not dream of going into Jones's house and taking his money or silver, will just as effectively rob him by evading his own proper share of income tax.

Still, the attitude of the ordinary man to that abstraction which is called the State has perhaps somewhat improved since the days of Charles Lamb, who said with regard to smuggling, "I like a smuggler, he is the only honest thief, who robs nothing but the revenue—an abstraction I never greatly cared about."

Byron, too, wrote to Moore in June 1815, when the rate of income tax was 2s. in the £:

A word more;—don't let Sir John Stevenson (as an evidence on trials for copyright, etc.) talk about the price of your next poem, or they will come upon you for the *propérty* tax for it. I am serious, and have just heard a long story of the rascally tax-men making Scott pay for his. So take care. Three hundred is a devil of a deduction out of three thousand.

It needs a well-developed civic sense to feel as deeply conscientious in small matters in our relation to the State as in matters which immediately and personally affect people about us. Four distinct attitudes of mind may be noted. First, it is never difficult to find some real or fancied inequity in the State procedure towards us which will serve as a justification for "getting our own back," and this quickly serves to appease a scruple or condone the offence. If a man has suffered at the hands of the State by payment of tax on something which he thinks should have been free, he will often take the "squaring-up" process into his own hands, and use the first opportunity to get even. Secondly, since the State has put up various protective devices against fraud and evasion, there is to some people a certain kind of fascination in getting through them unscathed—something a trifle smart or romantic, in an otherwise drab world, which may be boasted about with great credit after dinner. Thirdly, the feeling that other people similarly situated are not paying "their whack" apparently almost impels some to protect themselves, or get on to an equal footing. At any rate this extenuation is very frequently put forward. If there is any distinction

to be drawn in this matter of everyday evasion, it is perhaps that people think the more passive an action, the less blameworthy. The omission of an item of income from charge is thought excusable, whereas the overstatement of one's insurance or the number of one's children in order to get greater allowances is rather like a criminal act. The smuggling through of dutiable articles for personal use seems to be a far less heinous offence than getting goods past the customs which are to be sold in the ordinary course of business. Fourthly, when we leave the region of indisputable facts and come to the region of questions of degree or of opinion, human fancy excels all, in giving itself what is euphemistically called "the benefit of the doubt." Most men would scruple to give a false statement of the actual rent they pay or receive, but if they have to give the rental value of property they occupy—say for the purpose of local rating—many do not hesitate to put the lowest credible figure, certainly lower than they would accept in the market. They would not understate a holding of shares for estate duty, but they would put the lowest conceivable value on their furniture and similar possessions subject to valuation. The same thing happens in getting goods passed on *ad valorem* tariffs—it is always "up to" the State to give effect to a different opinion. Similarly in the vital factor of "stocktaking" for a specially heavy duty like Excess Profits Duty, the stocktaker may adhere rigidly to the rule "stock to be taken at cost price or market value if lower," in so far as the market value is a

figure which may be tested by comparison with prices outside in the market. But with goods in a half-finished condition which cannot readily be compared with similar goods there is room for some difference of opinion, and here some managers in the past have had shocking fits of pessimism.

It was mid-Victorian wisdom to adopt such taxes that the taxpayer would hardly realise he was being taxed, and thus avoid tempting him into a liar. But opinion to-day is that it is a good thing that the taxpayer should feel something of the burden, and that taxation must be settled on its merits as for reasonable citizens, honest and honourable, and should not be conditioned by the aspect of dishonesty and evasion. On the whole I am inclined to think that the general sentiment of tax honesty in this country was rapidly improving prior to the war. But the fever of profit-making and the high rates of taxation brought about a bad relapse, and it has recently been estimated that the loss in income tax and Excess Profits Duty in the last few years has. amounted to over 100 million sterling. The slightest alteration in profits was so costly under Excess Profits Duty that these figures must be regarded as quite exceptional, and as not giving a proper recognition to the real honesty of the average taxpayer. But the State must look rather carefully before it adopts any tax in which it is likely to be quite powerless against fraud, or can only protect itself by imposing such conditions on everyone as to make the scheme burdensome. For the taxpayer is none too reasonable in the matter. In one breath he is

loud in his complaints as to the amount of evasion and the way in which the Revenue allows itself to be cheated, and in the next he hotly resents some personal question addressed to him on his own tax returns, failing to recognise that he himself cannot escape the tests provided for carrying out his own policy. It may be taken as axiomatic that the more closely the tax conforms to just principles the more open it will be to evasion, and the problem for the State is always how closely to conform to principle without giving up its safeguards.

[The attitude to evasion varies greatly in different countries. It was said in the French Chamber of Deputies (1926) that in England, if a man had been suspected of fraud by the Administration, he would find, on arriving at his club, a reluctance to shake his hand; whereas, in France they would crowd round to know how he did it. Deputy Tarso interposed with: "In France they make him honorary president of the club." Although on the whole commercial and judicial morality is not so high in America as in Britain, there is a curious divergence of attitude on this subject. It is well laid down here that a taxpayer must be "caught" by the actual words of the Statute—never mind the intent of its framers—otherwise he is free and "no blame to him." If he can so arrange his affairs as not to come within the verbal net, he can have the benefit of his ingenuity, and the Revenue have no remedy but to tighten up the law. But in the States, there can be an offence against the "spirit" or intent of the Act, and this is freely played upon in the proceed-

ings. Recently in Germany, action, though grammatically not against the law, has been held to offend against public policy as "illustrated" by the Act.]

7. *Automatic Checks upon Evasion*

In the imposition of many different kinds of tax the State may provide its own remedy, one acting as an automatic check upon the other. For example, the ascertainment for house duty and rating of the annual value of residences forms a rough check upon the statement of income of the resident.[1] Estate Duty returns are checked to some extent by those parts of the prior income tax returns which were not readily open to evasion. The duties payable under Excise and Customs are used in many countries as presumptive checks upon the accuracy of returns of profits. But of late years a still more effective check, almost in the nature of retribution, has come to light, especially in the fourth section to which I have referred, viz. a realm of valuation or opinion, for under an *ad valorem* customs duty, which of course is the most just and also the most difficult form, the tendency to undervaluation is checked by the State having a right to pre-emption, *i.e.* the right to take over the goods at the value set upon them by the owner.[2] This certainly secures a useful lower limit to values. Somewhat similar is the claim of a community to acquire land or property on the basis of the value on which the

[1] *British Incomes and Property*, p. 459 (S.).
[2] Higginson, *Tariffs at Work*, p. 65.

owner has paid taxes, which can be used with great effect to maintain assessable values.

Government Departments in some instances during the war secured the right to acquire plant and buildings at the value to which they might be written down at the end of the war for Excess Profits Duty, and this was some check upon the zeal of the taxpayer in claiming the depreciation allowances. In the case of undeveloped land duty, the interests of the taxpayer dictated a low value (for he had to pay an annual tax upon it), but for the Increment Value Duty he would wish for a high value, since it formed the datum line from which to measure future increments. Similarly the taxpayer wanted a high value for Increment Value Duty, but at the same time had his eye upon a low valuation for Estate Duty.

Compensation on the basis of taxation has always been a familiar dilemma, and it is wonderful how tax returns go up on the rumour of an improvement scheme. I remember very well when the Licensing Acts first came into action, dispossessed licences before the Licensing Magistrates claiming to " do " four or five barrels a week, who had perhaps a short time earlier, before the same individuals sitting as tax commissioners, put their trade at two or three barrels.

Many taxpayers who were quite proud of their prowess in securing good terms for themselves in the assessment of profits during 1912 and 1913, lived to regret their skill when those years formed the datum line from which to measure excess profits during the

war. The rubber industry had revelled in a High Court case decision (thought by some to be of doubtful validity) which enabled them to claim considerable capital development expenditure as a deduction from profit in pre-war years for income tax, but found under the Excess Profits Duty that they were doubly hit, for if they took a profits standard, their pre-war profits had been reduced for taxation purposes, and if they took a percentage on capital as a standard, their development expenditure had not been put to capital but to revenue. No wonder that the taxpayer has asked for the best of both worlds. The capital values adopted for Excess Profits Duty may also have a reflex action upon Estate Duty. Under the proposed taxation of war increases of capital, the suggestion is that the taxable field shall be the difference between a valuation of the individual's wealth in 1914 and the same person's wealth in 1919.[1] So his desire would be to make the 1913 valuation as high and the 1919 valuation as low as possible—his memory, reversing the usual process, must be good for the earlier years and bad for the most recent.[1] It has been suggested that anyone who has kept no record of what his possessions were in 1913 might capitalise his income as returned for income tax or super-tax in that year. This is a refinement of cruelty worthy of the Spanish Inquisition. The taxpayer certainly bids fair to be in a worse dilemma than he was placed in by the Excess Profits Duty.

[1] Committee on Taxation of War Wealth. *Vide* Evidence (S.). [Also "Taxation during the War" (S.) for various other examples.]

Equally at the present time there is the devil and the deep sea for those who look forward to the doubtful choice between a capital levy and a graduated tax on business profits on the American model. What does the taxpayer desire to have regarded as the capital value of his business ? For one tax he would like it as high as possible, and for the other no figure could be too low to please him.

Where the profits of a single business have to be divided between two taxing jurisdictions, as for instance in the determination of the profits arising in this country from a cable with America or of a meat-importing company, there is great room for ingenuity in the selection of methods of determination which shall throw the weight of profit into the area where taxation is lightest.[1]

Although Italy has a system of income taxation which has more resemblance to our own than most taxes, under-assessment has in the past been so regularly recognised that it seems to be generally practised without thought of fraud.[2] It is of course possible to imagine a State in which the public conscience is so highly developed that, with a little assistance in interpreting the law so that the taxpayer may be protected from being led by his own zeal in meeting his full liabilities to over-assess himself, self-assessment may be safely indulged in. Adam Smith tells us of a remarkable instance, which is worthy of the communal spirit of the early Christians : " At Hamburg, every inhabitant is

[1] *Vide* also *E.J.*, 1912, p. 126 (S.), and *E.J.*, 1913, p. 145, and the provisions of the American and Colonial Tax Acts.

[2] Kennan, *Income Taxation*, p. 154 ; Vidal, *L'Impôt sur le revenu.*

obliged to pay to the State one-fourth per cent of all that he possesses. . . . Every man assesses himself, and, in the presence of the magistrate, puts annually into the public coffer a certain sum of money which he declares upon oath to be one-fourth per cent of all that he possesses, but without declaring what it amounts to, or being liable to any examination upon that subject. This tax is generally supposed to be paid with great fidelity. A similar mutual confidence exists in Underwald and Zurich. A sober and parsimonious people having no hazardous projects of trade do not feel that they have occasion for any concealment." [1]

8. *Communal Evasion*

A State has to contend frequently not merely with evasion by individuals but also with what I may call "collective or communal evasion." If it adopts the expedient of getting revenue from smaller areas comprised within it—in respect, let us say, of its expenditure of a local character—it frequently apportions the total charge amongst them according to their aggregate assessments to a given common tax. Obviously, in a given area, the total tax raised for that area may be fairly apportioned amongst its inhabitants, even though *all the assessments* are *half* what they ought to be. But that area will score heavily compared with neighbouring areas where the State tax is apportioned. Thus in the United States, in many cases State or County

[1] *Wealth of Nations*, vol. ii. Part ii. Art. 2.

expenditure was spread over the township on the basis of the general property tax. As the methods of assessment to this tax had gone all to pieces, and the ratio of assessed value to true or full value varied from 10 or 20 per cent to 80 or 90 per cent, it is clear that the gravest inequities arose. The State Boards of Equalisation were begun partly to meet this evil, and partly to deal with the proper assessment of large corporate concerns with property in many different areas, where local assessors were powerless. These equalisation boards in some instances evolved into the State Tax Commissions which are doing important work.[1]

Years ago it was quite common for the rate values in an English parish to be far below the true rental values, and even now some parishes rate on only about 50 per cent of the rack rental.[2] Special provision had to be made when the Imperial income tax was imposed, so that in so far as the rating was utilised as a basis this feature should not prejudice the uniformity of assessment to property tax. So far as the parish is raising revenue for itself, it matters little, provided that the valuations are in proper proportion to each other—the rate in the £ of the tax is *pro tanto* higher. But when the quota to be borne by the parish out of the union expenses is being fixed, it becomes important, and the union assessment committees frequently take steps to get proper equalisation.

In the same way if a union as a whole is under-

[1] H. L. Lutz, *The State Tax Commission*.
[2] "Land Valuation and Rating Reform," *E.J.*, 1911, p. 25 (S.).

rated it gets overhauled by the county authorities when the county rate is being determined. [These difficulties are now much less than they used to be, partly owing to the much larger area of the units of assessment authority.]

I may perhaps leave the subject of evasion by quoting an early attempt at an up-to-date type.

In the *Anti-Jacobin*, 1798, there is a burlesque at the expense of the Duke of Northumberland, who, besides avoiding the powder tax by getting his servants to stop using powder, had claimed a deduction in respect of his eight children from the Triple Assessment, the immediate forerunner of the Income Tax, under a provision which had been made for the relief of the poor tradesman or manufacturer with a numerous family. It concludes with these verses :

Again the Taxing-man appear'd—
  No deadlier foe could be ;
A Schedule, of a cloth yard long,
  Within his hand bore he.

" Yield thee, Duke Smithson, and behold
  Th' assessment thou must pay ;
Dogs, horses, houses, coaches, clocks,
  And servants in array."

" Nay," quoth the Duke, " in thy black scroll
  Deductions I espye
For those who poor, and mean, and low,
  With children burthen'd lie.

" And tho' full Sixty Thousand Pounds
  My vassals pay to me,
From Cornwall to Northumberland,
  Through many a fair county ;

"Yet England's Church, its King, its Laws,
Its cause I value not;
Compared with this my constant text—
A *penny saved is* got.

"No drop of Princely Percy's blood
Through these cold veins doth run,
With Hotspur's Castles, *blazon*, name,
I still am *poor* Smithson.

"Let England's youth unite in arms,
And every liberal hand
With honest zeal subscribe their mite
To save their Native Land.

"I at St. Martin's Vestry Board
To swear shall be content,
That I have children eight, and claim
Deductions ten per cent."

God bless us all from factious foes,
And French fraternal kiss;
And grant the King may never make
Another Duke like this.

9. *Taxing by "What the Traffic will bear"*

If the State is taxing for revenue only, the effect of an increased tax on a commodity upon its own revenue from that tax through diminished demand following an enhanced price has always to be most carefully considered, and in the case of Excise and Customs duties is generally found rather troublesome to estimate. It is obvious that if the commodity is one for which the demand is fairly elastic, a small increase in price may cause a heavy falling off in demand, and in the net result less revenue may come in than before the duty was

increased. It is a problem very similar to that involved in fixing railway rates, in finding "what the traffic will bear." The Government has to prognosticate the elasticity of demand and this is naturally a most difficult problem. It is not merely that fewer people will want to buy, or will have an effective demand at a higher price. The law of substitution may operate, and people will find a way of satisfying the same wants by recourse to other articles—alternative beverages or alternative methods of lighting are cases in point, and the principle is so obvious that I need not labour it here. [The analogous problem arises when two heavy graduated taxes are applied to the same source of wealth, especially a steeply progressive tax on estates and another on the income from them. Each tax tends to eat into the future of the other. This was a major factor in the non-economic results of a projected Capital Levy.[1]]

10. *Political Aspects*

Will a proposed tax raise political difficulties at home or provoke unrest? This is peculiarly a question for each country to decide for itself without reference to others. Can any one explain why the Match Tax should have had such a remarkable fate? A differential tax upon a form of wealth

[[1] *Vide* "Current Problems in Finance and Government" (S.), chap. xi., where it is shown that approximately two-thirds of the Levy would be absorbed in making good its depredations in other taxes. For the effect of high surtaxes and estate duties *vide Journal of the Royal Statistical Society*, May 1936.]

which is predominantly identified with one political class brings about its own peculiar political difficulties. This is illustrated in many countries between the agrarian interests—usually conservative—and the manufacturing interests—usually liberal—in the settlement of tariff policy. Students of German and American tariff history will be thoroughly acquainted with the fact that rival taxation programmes may form the basic whole of political contests.

The Land Taxes of 1910 may be said in many ways to have raised political issues on party lines—at any rate, if it was not actually foreseen at the time of proposal that they would do so, they had that ultimate effect. In some countries where such matters are more important than here, the political issue may be a matter of jealousy between the legislative and executive wings of the government.

A good example of pure revenue policy being materially affected by political considerations is the adoption of the French Minimum Tariff. The general or conventional system as adopted by Germany and many other countries is the establishment of a general tariff, and then by reciprocal treaty concessions making reductions on such a tariff to form what is known as a Conventional Schedule. The French system prescribed a minimum below which the tariff rates could not be lowered without the authority of the Legislature, as a check upon the executive authority and plutocratic power. This is supposed to have the advantage of giving the fixed degree of protection and stable conditions

for industry without all kinds of official variations.[1] Similar jealousy of one section of the administrative power may be found in connection with the Dingley tariff. Tariff negotiation is, of course, a somewhat delicate matter and is much better dealt with by ministers and officials than by open discussion in legislatures.

11. *Conflict with other Jurisdictions*

The great dilemma before State administration throughout the world at this time, in various forms, goes right down to fundamental principles. It may be described as the conflict between " situs " and " ownership " as the basis of liability to taxation, or, to take the terms now becoming familiar, between " Origin" and " Residence." [2]

Twenty-five years ago, when the taxable capacity of Ireland was being investigated and vigorously discussed, this difficulty ran throughout the matter, but was never really laid bare.[3] What is the taxable capacity of a country ? Is it what the residents in that country can afford to pay, or is it what the income produced in that country can justify ? Suppose that all the property in Ireland belonged to Englishmen resident in England, and all the property in England to Irishmen resident in Ireland, would the taxable capacity of Ireland be greater or

[1] Higginson, *op. cit.* p. 13.

[2] 1920 Comm. Evidence, 9573, etc. (S.) ; Appendix, " Report of Sub-Committee on Double Taxation," p. 171. [Very fully dealt with in the Report on Double Taxation, 1923, made to the League of Nations by Professors Bruins, Einaudi, Seligman, and the writer.]

[3] *British Incomes and Property*, pp. 367–9 (S.).

less than that of England? Are we considering the taxable capacity of a *people* or not? We are back to the old contention that taxes are paid by persons and not things. If you want to see how deep-rooted is the instinct to tax on two principles, imagine the feeling of an Irish Government imposing a separate income tax. Would they refrain from taxing a property in Sligo merely because the income from it went abroad? One imagines that they would feel it was specially chargeable. But suppose that a millionaire settles down in Sligo who draws all his income from England, would they decide to exempt him? Certainly not. It is very difficult for States to make up their minds which principle to adopt, and most of them end in taxing under both principles, hence the great problem of double taxation, which exists not merely as between this country and the Dominions,[1] but also as between the large and the small jurisdiction wherever federal government is found, and where co-equal jurisdictions exist within one economic sphere. Any one who wishes to study the extraordinary problems that arise will find them fully and freely illustrated by State taxation in the United States. By way of example take mortgages, under the General Property Tax. A. resides in New York and has lent money on mortgages on a property in Kentucky. The Kentucky authorities tax the property in full, and think they have the clearest possible right to do so. But, under the theory of

[1] On the whole subject *vide* 1920 Comm. Evidence and Report [and Double Taxation Report cited on p. 130.]

the tax, a resident has to make a return of his whole property, and the New York resident is also supposed to "show up" the mortgage. Both sides defend their claim on principle by most extensive arguments. A recent writer says: "The old, old break in logic of course comes at this point. The property mortgaged is already assessed—the successive assessment of the mortgage is a second assessment on the *same property* or rather on the *income* of the same property. The answer of the proponent of credit taxation reveals the wide difference in thought of those who favour exemption of credits from those who favour their taxation. The taxation man says—'The owner of these credits enjoys an income, has a property right in his possession, and is as able to pay a tax as the man who happens to hold the physical property.' One thinks of taxing *things*, the other of taxing *persons*. The whole history of the futile attempts to tax credits is a history of this hazy confusion of thought. The man who proposes to exempt credits argues logically on the basis of the taxation of *things*, his opponent presses with equal logic the argument for *personal* taxation." [1]

The existence of intangible credits, especially in a form other than mortgages, brings out the full weakness of the property tax—the conflict of jurisdictions. The physical *property* where situated is located and taxed, the intangible is assessed and taxed to the owner where he resides, both on the legal theory that personal property follows its

[1] *Readjustments*, p. 96.

owner and on the economic theory that the *person* owes a tax allegiance to the *place* where he lives.

It was not merely in economic principles that the difficulties existed. " The real break-down was in administration. Real property can be seen and cannot escape. But intangible property like credits, mortgages, stocks, etc., were *veritable* will o' the wisps of taxation." [1]

The assessor had not only to detect the presence of property, but must ferret out as well its quantity and its kind. And he was a locally elected officer in a government whose fundamental administrative theory has always been that efficiency consisted largely in getting re-elected. To do his duty he must antagonise those to whom he must appeal to hold his job. And if this were not enough the work he did was looked upon with disfavour by all who could really have done it, and the salary was fixed at about the value of the sort of men willing to accept it.[2]

The practical difficulties have led to many solutions. As regards mortgages the changes have been summarised in eight classes :

1. Exemption.
2. Taxation as a share in the property, at the situs of the property and accompanied by a prohibition of any contract by which the mortgagor might agree to assume the tax (California).
3. The second plan without prohibiting contracts—a plan really amounting to exemption (Wisconsin).
4. A low rate of taxation imposed when the instrument is presented for recordation (New York).

[1] *Loc. cit.* [2] *Loc. cit.* p. 98.

5. A reduced and fixed rate of taxation, assessment made as before (Maryland).

6. A rigid system of private and public spying with liberal rewards to the spies (Ohio-Iowa).

7. A rigid centralised administration and a limited rate for all property (Ohio).

8. Substitution of a progressive income tax for all taxes on intangible personal property (Wisconsin).[1]

It would take far too much time for me to indicate the numerous reasons given for these different types, but of course the majority are really indefensible in principle. Another writer has said that double taxation prevails to a greater extent in the United States than in any other part of the civilised world. This is primarily owing to the complexity of the system of government, "whereunder the citizen and his property are subject to the taxing power of two distinct sovereignties, the State and the United States, and to the general ignoring of inter-State comity in the exercise of the taxing power by the States over the persons and property within their own jurisdiction."

Some effort is now being made by the separate States to avoid this class of double taxation. The method adopted in California and Oregon of taxing the separate interests of the mortgagee and mortgagor has been upheld as valid under the Constitution by the Supreme Court. In practice it has been impossible to prevent the mortgagee from evading by forcing the tax on the mortgagor as a condition of the loan, or by omitting it from his

[1] *Loc. cit.* p. 98.

property. It has been said that an effective system of taxation which cannot be evaded will tend to bring about equality, while a tax levied without regard to effectiveness, though ostensibly equal, may result in the grossest kind of inequality.

Another type of double taxation in the States is the taxation of the same actual property in the State where it is situated, and also upon the owner resident in another State, and in this respect the inheritance tax laws of the States run riot. Company shares are a common case. I have read of one instance where railroad stock of the deceased was subject to the tax of Wisconsin because this State was his residence ; in Illinois because the stock was physically in that State, being kept in a safety deposit box in Chicago ; and in Utah because the railroad company is a Utah corporation.[1]

The National Conference on taxation resolved : "*Whereas*, The problem of just taxation cannot be solved without considering the mutual relations of contiguous states, be it *Resolved*, That this conference recommend to the States the recognition and enforcement of the principles of inter-State comity in taxation."

These principles require that the same property should not be taxed at the same time by two State jurisdictions, and to this end that if the title deeds or other paper evidences of the ownership of property or of an interest in property are taxed, they shall be taxed at the situs of the property, and not elsewhere. These principles should also be

[1] *Loc. cit.* p. 89.

applied to any tax upon the transfer of property in expectation of death, or by will, or under the laws regulating the distribution of property in case of intestacy.[1]

Opinion in the United States has hardened to the view that a federal inheritance tax is an unwise and improper encroachment by the federal government into a just and proper field of State taxation.

It may be remarked that, so far as our own system is concerned, Estate Duty is not chargeable upon real property situated aboard.

The acute problem of double taxation within the Empire is in all our minds. The United Kingdom was first in the field, and taxed on the principles of residence, origin, control, and every other pretext it could invent, on the Donnybrook Fair principle, "See a head, hit it." Now that the Dominions have heavy taxes of their own, we are faced with the problem of principle. Some of the Dominions charge on both principles of origin and residence but others confine themselves to income arising within their borders. France has been quite modest in her new income tax and has not charged income arising out of France.

The question as to what shall be given up by the respective Exchequers in granting relief is of course complicated by rights of possession, and by the question of the obligations on expenditure incurred by the Home Government.

Is any ground of principle at all to be appealed

[1] *Loc. cit.* p. 111.

to in all this? My own view I expressed in evidence recently as follows:[1]

"In a world in which there are no vested national interests, where perfect reciprocity reigns, and where an income tax similar in character exists in each country, I imagine that its distribution might be ruled according to the following principles:

"The tax that a man is called upon to pay to the State may be said to be divisible into two parts, that which is due for the specific protection and maintenance of particular sources of income, and that which is due for the privileges which the citizen himself enjoys in his person and residence. I think no one would contend that the Australian Government has no right to make any charge in respect of a farm there merely because its net produce goes to an English resident; similarly, no one would admit that the English resident should be free from all obligation to the British Government merely because his income is derived from abroad. It is often serviceable to remember that our income tax is a combination of these two separate taxes, and the Commission may recall that the confusion that has arisen in the past on the subject of the taxable capacity of Ireland had its origin in the failure to distinguish these elements. It would seem to me that the origin tax, taken separately, might fairly be levied on the benefit principle, and be a flat rate, *i.e.* proportionate to the magnitude of the interests protected—a sort of fee or charge. The Australian Government would charge the same amount for

[1] 1920 Comm. Evidence.

their services to the farm, whether the English resident were a millionaire or a poorer man. There are, of course, considerations which would make the amount of the tax diminish with increasing magnitude of the interests, but I think, on the whole, they are not important. The resident's tax, however, must necessarily be according to ability, and therefore, in my judgement, progressive. Speaking generally, upon incomes of considerable amount, it would be much the larger tax. Where origin and residence are in the same country, we can well afford to blend the two into one composite tax, and even admit the principle of degression, remitting part of the fee, applicable to origin, chargeable upon poorer people. As soon, however, as origin and residence are distinct, there would appear to be no theoretical reason why the distinction should not make itself effective. In the application of this principle, therefore, each country would charge a combined tax upon its residents for their income derived within the country, a resident's tax for the income derived from abroad, and an origin tax for all income going out, the net result being that there would, apart from slight differences in rates, be no problem of double taxation.

"The full application of such a principle in present circumstances is, of course, impossible.

(1) There is no general reciprocity likely, and the tax systems and principles of different countries are very various.

(2) A piecemeal system admitting the principle would be very difficult, because, in relation

to each of the countries considered, we are either a debtor or a creditor nation. The nations who stood to gain by it would come in with us, and those who stood to lose would stand aloof. Moreover, the practical difficulties on accounts on a piecemeal system would be enormous, as the trade carried on by various businesses does not fall conveniently and separately into different countries, and is very often merged and indistinguishable.

(3) The amount of revenue to be given up by this country would be very large, and conformity to a mere abstract conception would be too dearly purchased."

I certainly think that a State can tax beyond its borders in respect of the property it protects, but that it can most fairly do so on the benefit principle or a flat rate. In this country we do not now allow a foreigner living abroad any abatements, etc., in respect either of his total income from all sources or his income from this country.

How have such federal constitutions as Germany and Switzerland dealt with this problem? Generally double taxation is prohibited, and income from real property is treated as left to the State where it arises, and all other incomes follow the residence of the taxpayer. Thus, land in Baden, owned by a resident in Prussia, is charged in the former State. His tax in each State is at a lower scale than his total income would justify. In other instances the rate of duty charged is determined by the *total*

income, but that rate is applied to the limited income only.[1] But the double taxation as arising between units *not* within a federal union is a medley. A kind of reciprocity for avoidance of double taxation existed between Germany and Austria before the war. [The complicated arrangements elaborated by the League and the International Chamber of Commerce do not adopt any undiluted principle. The original report (cited on p. 130) recommended the "reciprocal exemption of the non-resident," wherever possible, but where there was reluctance to abandon the principle of origin, a mutual *ad hoc* convention, balancing the respective losses, was necessary.]

If we suppose that all countries agree to tax by origin only, State troubles would by no means be over. Take the case of a company with orchards in Canada, packing establishments, box-making, etc., in Chicago, jam-making in the United Kingdom, and retail sales in India, Australia, and Japan—where do the profits *arise*? The division of profits according to the place of origin presents an almost insoluble problem in accountancy and is, of course, not strictly determinable. Many authorities leave each case to be discussed on its merits. But in some cases general principles are formulated. Take Wisconsin for example:

"The Statute authorises a computation by taking the gross business in dollars of the corporation in the State and adding the same to the full value of the property of the corporation located in

[1] *For. Income Taxes*, 1913, p. 16.

the State. The sum thus obtained is used as the numerator of a fraction—the denominator of which is to consist of the total gross business in dollars of the corporation both within and without the State added to the full value of the property of the corporation within and without the State. The quotient of the numerator divided by the denominator is a decimal which indicates the proportion of the whole net income which should be apportioned to Wisconsin.

"This somewhat complicated and arbitrary method is applied quite frequently, but sometimes leads to grotesque results. For example, a foreign corporation may have a large amount of property in Wisconsin, but its business, so far as Wisconsin is concerned, may be carried on at a great loss. Nevertheless, if profits have been large in other States, the application of the above rule might show a considerable income for Wisconsin. Yet on the whole the plan has worked more smoothly than was to be expected." [1]

12. *Conflict of Sub-jurisdictions*

In the problem of the State and its constituent areas there are three kinds of solutions :

(*a*) The State may raise its revenue by applying a surcharge to the local revenues, leaving the local areas free to administer and assess how they wish. This is the method often followed in American States, which secures a percentage upon the general

[1] *Readjustments*, p. 72, and *E.J.*, March 1913 (S.).

property tax in each local area in the State. Something like this is the net result of the British method of spreading the county rate over the parishes in the country, but so far as the whole Government is concerned the method is inapplicable.

(*b*) The second method is for the State to apply a tax over the whole area under its centralised administration, and for the local areas or townships to get their revenues by way of surcharges on the State revenue. This is the German method. To the Prussian State income tax in each local area is added a special percentage settled, within limits, for that locality.[1]

(*c*) The third method is what is known in America as segregation of the source, or separation of the revenues, in which the State and the local areas each have independent and appropriate sources of revenue. For example, the local area is free to have licenses, fees and taxes on real estate, like rates, while the State takes customs and a general income tax. It is difficult to say at the moment, under the special conditions introduced by the war, which is actually gaining the day as an accepted principle, but separation of the source is not quite the fetish that at one time it seemed to be.[2]

[1] Departmental Report (1910) on Local Taxation in Prussia; also *Statistical Journal*, April 1912, p. 487.

[2] *Readjustments*, p. 131, chapter on "Separation of State and Local Revenues" by Professor T. S. Adams.

CHAPTER V

THE STANDPOINT OF THE COMMUNITY: ECONOMIC EFFECTS

1. *Economic Effects may be distinguished from Incidence*

We have now to consider the attitude of the community, in its social and economic activities, towards questions of taxation. It is conceivable that the individual taxpayers might be satisfied that a proposed burden was equitably apportioned between them, and the State as tax-gatherer might be equally complaisant, but that at the same time the business world might find the particular kind of tax objectionable as a hindrance to trade, to the accumulation of capital, or to particular kinds of investment. I have reserved for consideration here the general effects of taxation, after the individual has found a way to pay it, and the State has found a way to collect it. It is commonly recognised that the incidence of taxation is a very intricate problem, which for its elucidation in many cases requires great powers of abstract economic analysis. When we inquire into the incidence of a tax we usually mean "by whom is the tax finally paid?" and

when we speak of effects, we have in mind something beyond the incidence—whether the conduct of the payer on account of the tax is modified in such ways in his economic relationship to others as to alter the equilibrium of business.[1] For example, we should agree that although the importer pays the tea-duty, its final incidence, *via* the wholesaler and retailer, is upon the consumer. But its *effects* may be more far-reaching. Does it diminish the consumption of tea and increase the profits of the cocoa dealers, or does it diminish the demand for children's boots, or is the effect generally diffused over all business? Would a "turnover" tax have the effect of throwing business into the hands of large firms which controlled various stages of manufacture ordinarily carried on by separate firms, owing to the fact that in the former case the tax would be payable only once, and the aggregate price effect of the latter could therefore be undercut?

I do not disguise the fact that this subject is the most difficult one of all those dealt with in these lectures, for if it is to be dealt with properly it demands on the part of all some knowledge of economic principles and the habit of economic reasoning. I do not propose to deal with the ordinary questions of incidence that may be found in text-books—such, for example, as the fact that taxes on monopoly produce tend to be borne by the monopolist, and that taxes on monopoly profits

[[1] This distinction between incidence and effects was very fully worked out by the Colwyn Committee Report, 1927.]

cannot be shifted, and so forth. Neither can I cover the whole ground, except by the not very illuminating process of quoting a series of conclusions. So I propose to deal with two or three questions rather more fully and by way of illustration.

2. *Capitalisation of Taxes*

The principle of capitalisation, or amortisation as it is sometimes called, is so far-reaching and insidious that some reference should be made to it. An attempt to tax by a special tax any particular kind of interest or return on capital can rarely be carried out properly—it nearly always amounts to confiscation for the present holders, so that all future owners are relieved from the burden. For example, suppose it should be decided that all dividends of gas companies must bear a special tax of 4s. in the £, or one-fifth of the income. No one looking round for investments would think of putting his money into such shares without taking the burden of the tax into account, in order that after paying it he might be in the same position as if he had invested in other shares of a like quality or security, which he could only do if he paid a price reduced by 20 per cent. One would expect prices of gas shares to drop to this extent in the market, and if any present holder wanted to sell, he would suddenly find one-fifth of his capital confiscated, although the tax is ostensibly a tax on income. In no case does a future holder by pur-

chase pay the tax, for he gets a full market yield of interest.

The one condition is that the capital in question must have a free current yield which is on comparable terms with other forms of interest, and is therefore bought and sold in the market. But the effect here is not quite final. In the case of *new* openings for such capital, the offer to be made by the promoter must allow for the burden, otherwise the issues will fail by competition with the general return on capital. One of two things must happen: *either* the demand for gas is inelastic, and people must have it whatever it costs, in which case the quantity of gas consumed will be unaffected, but its price will be higher because of the special burden; *or* the least eligible propositions for gas production will not mature, because they will no longer be paying propositions, and the restriction will come back upon the public in this way. Gas production is peculiar, and admits of little competition. If the product is in free competition with large supplies from untaxed sources, the price cannot be greatly revised, and the special burden tends to be borne by "home" business in a restriction of supplies.

A distinction must always be drawn between the effects of a differential tax on *existing* yields and that upon future openings for investment; and the economic effects are different again where the tax is a differential tax upon the whole *profits*, rather than upon the economic share of *capital* as such.

Just as a differential tax tends to be a confisca-

tion of values for present owners, so a differential exemption or privilege tends to be a bonus to present owners. Suppose the State decided to give gas dividends a special exemption in a tax that is otherwise general. Present holders enjoy a privilege which is worth money, and when they sell shares they can capitalise practically the whole of the benefit in extra price, for no holder is going to let a buyer have a special privilege without paying for it in full, and, virtually, the buyer finds himself with the general market yield on capital.

3. *Examples of Capitalisation : the Land Tax*

The effect is not really dissimilar where the tax is partly on economic rent and partly on interest. A good example of an " old tax being no tax " is the old Land Tax. We now find that a given piece of land has a practically fixed annual charge attached to it, like a feu-duty or ground-rent, and indistinguishable therefrom in its effects. Is this a *tax* or not in the ordinary sense ? Some twenty years ago, when the burdens on particular classes of property were being considered, I remember that one high official gave it in evidence as his view that the Land Tax was not a tax at all any longer, for it was taken into account by every purchaser in the price. Even when land has passed by inheritance it has had only the value as reduced by the fixed charge since the time of the first imposition. Can this be said to be any *tax* on the present generation ? Does it represent any sacrifice, like a tax, to inherit a piece of land

for which no one can remember ever getting the full rack rental?

On the same occasion another official took the view that the Land Tax was a tax, and so we find the unique feature of a Chairman and a Deputy-Chairman of the Board of Inland Revenue taking directly opposite views on a question of principle.[1]

It is quite obvious that suddenly to give up the old Land Tax would be an immediate bonus of its capitalised value to the vast majority of owners, exactly the same as if feu-duties or chief rents were cancelled. But as recently as 1894 the State did not take the "rent-charge view" very decidedly, for it said that people with incomes under £160 should have the charge remitted, and others with small incomes should have it halved, and it therefore treated the tax as a true tax.[2]

Here, however, the amortisation of the differential favour was incomplete, for the purchaser of land on which the tax was remitted was not entitled to the same privilege unless he were in the same economic position, and exempt from income tax. So if a millionaire was competing with a poor man at an auction for a piece of land, since the poor man could get a higher yield he was theoretically in a stronger position and could afford to outbid the rich man. The economic tendency of the exemption would appear, therefore, to be to give the poorer

[1] Royal Commission on Agriculture, Qs. 45,247, 63,085, 63,425, etc.; *E.J.*, 19th July 1911 (S.): *British Incomes and Property*, pp. 58 and 470 (S.).

[2] At the same time the burden was reduced to a maximum of a shilling in the £ on the rental value.

people economic advantages in this class of investment in competition with other investors which could not be enjoyed in other fields of investment, and so to throw the ownership of property into the hands of smaller people.[1] Of course, economic tendencies rarely have an opportunity to work themselves out fully, and much friction prevents the theoretical results from full realisation. Just as taxes tend to stick where they fall, so differential favours tend to stay where they are given. If it were not so, then the Agricultural Rates Act, in charging half-rates on agricultural property, did not benefit the farmers as ratepayers at all, but was a present to the landowners. Similarly, the unfair benefit which farmers were considered to enjoy for some years prior to the war, in having a virtual exemption from income tax upon their profits by reason of the fact that they were deemed to make only a sum equal to one-third of their rent for themselves, was an advantage that theoretically should have been absorbed by the landlord in enhanced rent. In all probability the duty involved was too small for the "friction" to be overcome.[2]

Now, lest you think me unpractical, may I give three instances in which the capitalisation principles may be an active question to-day?

4. *Recent Examples of Capitalisation*

The first example is in relation to the existing Excess Profits Duty. It will be remembered that

[1] *E.J.*, 1911, p. 30 (S.). [2] *E.J.*, 1911, p. 32 (S.).

when shipping profits began to boom in a most extraordinary way, the sale values of ships went up enormously. The owner of a ship could sell and realise what was practically a large part of the anticipated profit, and on this he was not liable to taxation, because it was a "capital" transaction. The purchaser, having regard to his high capital outlay, was often entitled to much better standards of profit or allowances for capital outlay, and higher depreciation allowances, and to such an extent, indeed, that where such changes took place it seemed likely that the Revenue would no longer get the large sums of duty from shipping that the amount of profit would otherwise have justified. The obvious remedy was to treat the sale value of the ships as if it were a taxable profit, and for a short time such a proposal was actually down upon the amendment paper. But, unless it formed a part of a *general* scheme of taxation of capital realisations, it obviously involved many anomalies, and the matter was finally dealt with in quite another way. It was arranged that the purchaser should be no longer allowed to have any greater privileges in the matter of allowances for capital and depreciation, despite his much larger investment, than had belonged to the vendor.[1] By the principle of amortisation the purchaser would then realise that, compared with other capital investments of a like amount, he was subjected to unusual tax discrimination, and, in order to get the current expectations upon his money, he naturally could not afford to offer so great a sum as he

[1] *Hansard*, 22nd June 1916, 385.

would have done if his taxation privileges had remained intact. In this way, in theory at any rate, the vendor was indirectly taxed upon the sale price, for the purchaser would throw all his special burdens into a depression of the purchase price. In practice, of course, whether these things really happened or not is not easily discerned, because where there is a great shifting of values, it is always difficult to disentangle the effects of a particular cause. This is exemplified in a striking way in the American Excess Profits or Business Profits Tax. You will be aware that this is a graduated tax in which a profit which shows a very high percentage on capital bears a progressive rate. For example, if the profit were 60 per cent on capital, the amount between 8 and 15 per cent might bear a rate of X, between 15 and 25 per cent a rate of 2X, and between 25 and 35 per cent a rate of 3X, and so on, so that by the time the whole 60 per cent had been taxed, it might be reduced to a net figure of, let us say, 40 per cent.

Here it must be remembered that the capital in question is not the share capital, but the whole capital, including reserves,—that is, the *cost* of all the assets.

Now let us suppose that the £1 shares of such a successful concern stood in the market at £8 before the imposition of the tax. If you bought these shares you would get a return on your money of 7½ per cent, which we will say, for argument's sake, is the current expectation in that industry. Now, if the distributable profit is suddenly reduced to 40 per cent, your investment of £8 will only bring

you in 5 per cent, and in order that the current expectation of 7½ per cent may be granted, the price in the market will sink from £8 to just over £5, and when you come to sell your shares the purchaser, in order to get his 7½ per cent, will only offer you just over £5, and you will have lost the difference. In your capital loss, therefore, you will have discounted the whole future tax of this exceptional or differential kind.[1]

Now whether or not the share values of highly successful concerns, in so far as they did not represent hard assets, actually exhibited such a drop, is not easy to determine, because, firstly, the tax was rumoured for a long while, and, therefore, the effect would not be sudden ; secondly, the tax was expected to be temporary only, and, therefore, to that extent, capitalisation of the burden would be unnecessary ; and, thirdly, the general values were altering rapidly. But there is little doubt that the sudden introduction of such a scheme, without any mitigating provisions, into a world of stable values, would have the effect indicated.[2]

The third illustration I shall give relates to double taxation. Suppose there are some shares in Australia which have been subjected to Australian income tax, and also to British income tax because the company is controlled in London, you would get a total burden of, say, 11s. in the £ on the profits. Presumably the new investor in the market buying such shares, as against shares which bore only one of the two taxes, would pay such a price as to get

[1] *E.J.*, 1919, p. 426 (S.).
[2] *Loc. cit.* p. 426.

rid of the additional burden, and to leave him with the current yield. Now if the whole of the special burden were suddenly removed, that purchaser is given the bonus of the capitalised relief, for the share purchased at a depressed value suddenly attains a *normal* value, just as the vendor would have suffered the capitalised burden when imposed. Fortunately, for the present problem, such sales cannot have been numerous, first, because of war conditions ; and, secondly, because existing holders, rather than sacrifice too much, will generally have held on to their shares until the promised relief from double taxation matured. In a similar way, if you get an anomaly such as is said to attach to the non-allowance of wasting assets, it may be a severe burden at the beginning, but, provided the rate of tax does not greatly alter, the industry may, so to speak, disperse the burden in the course of time, and return nearly the ordinary rates of remuneration upon capital and enterprise. Remedying the anomaly late in the day may possibly be little less than a present to the existing generation.[1]

I merely instance this, not as an obstacle in the path of reform, but only as a factor that has to be borne in mind, for the insidious effects of capitalisation of differential burdens run through practically all taxation problems.

5. *Capitalisation in Increment Duties*

An illustration of the principle in question which will be in every one's mind, is the final effect of the

[1] 1920 Comm. Qs. 9599 and 9744.

proposal to tax "increment," such as we have had in the Inland Revenue duties. It has to be considered that, in settling the valuation, every increase in sight is put into it, simply discounted for the length of time before it takes place, and for the probability that it may not occur. The value at the extreme limit of time that one can see or cares to reckon for, duly discounted, is the present value. It is said, therefore, to be impossible to have a prospective tax on the increment without depreciating the present value to the extent of a discounted burden. Any buyer who throws such a burden upon the vendor—and the whole burden of future taxation is on present earnings—will see at once that, in so far as a windfall occurs in a way or at a date not now anticipated, it will be successively taxed in due course.[1] This doctrine has been stated by Mr. Bickerdike along the following lines :

Any one who has paid that present value needs the increment to enable him to earn interest. To tax the increment simply knocks so much off the present value.

But do we really get out of difficulty even if we allow for interest ? Do we get, in theory at least, a tax on "unearned increment" pure and simple ? Is it not like a tax on winnings in a lottery, *imposed after the tickets have been bought* ? Land is bought with the knowledge that its future value is problematic. The purchaser gives a price for the probability. If you announce that all the chances that turn out well will be taxed, is it not exactly the same thing as knocking something directly off the present value of all the chances ?

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[1] *E.J.*, 1913, p. 194, etc. (S.); *Quarterly Journal of Economics*, Aug. 1915, article by R. F. Tucker.

Do we not then arrive at this conclusion, that the increment value tax is no different, as regards the question of incidence and of equity, from a simple tax on existing land values, and that it has this peculiar feature which differentiates it from all other taxes in force, excepting the old land tax, that the *true incidence of the whole burden, present and future, is on a limited number of existing owners of land?*[1]

Mr. Bickerdike rightly concludes that Mill, and others who have made no reference to interest, have failed to see that part of present value must be confiscated, and his criticism of the English Duty is so far just, but in so far as his criticism goes beyond the omission of interest, and he has in mind the omission also to deal with the "lottery ticket," I think his remarks require careful examination.

Probably Mr. Bickerdike would not wish to insist greatly on the practical value of his "lottery ticket." I feel somewhat in the position of the Irishman who had "never seen the kettle, and if he had it was lent him, and if it was lent he returned it, and if he returned it it was all right when he did so, and if it was broke when he returned it, well then it was broke when he first had it." For the real existence of the lottery ticket may be doubted, but if it exists it is not much good, and if it is, well it is not really a lottery, and no one has read what is on the ticket.

Apart from other important considerations, there is the mistaken assumption that the relation between lottery ticket values and lottery prizes is a simple *mathematical* one, and that a ticket is

[1] *E.J.*, March 1912.

"worth" the prize divided by the chances to the average person. The relation is far more of a *psychological* character. Is it to be understood that one grand prize of £1000 for a thousand tickets would give the same ticket value as five hundred £2 prizes? Indeed no, and the point of maximum appeal to the gambling interest is probably between these two, but generally it may be said that a little docked off the big prize would not affect the value nearly as much as a reduction of the *number* of chances. So a tax that "docks" something from the prizes will not have such serious results as one which proceeds to take the whole of every fifth prize away. The "demand" side is little influenced by the exact size of prizes, but greatly by the chances. Our assumed interest-free increment duty then will not have an exact mathematically-equivalent effect on values, especially when the prize is discounted over a long period, and we are thinking only of *present* values.

On the whole, it may be said that, "even in theory" Mr. Bickerdike's doctrine of universal incidence on present owners needs such severe qualification as to destroy its value as a valid criticism of an interest-allowing increment tax proposal. And in practice, too, it has very little semblance of truth. The statement that the true incidence, present and future, of a real windfall tax is on a limited number of existing owners of land, through the lottery principle, is similar in degree, if not in kind, to a biological assertion that some physical peculiarity that will some day be shown by

a living organism is existing or potential to-day in the antecedent ova several stages removed.[1]

6. *The Economic Effect of Death Duties*

One of the things most frequently urged against a tax is its effect in preventing the accumulation of capital, or in wasting capital. The Estate Duties have to meet such a criticism, and a little detailed examination may serve to indicate the line of approach to such a subject.

All taxation appears to affect capital accumulation, because if, *ceteris paribus*, it ceased to exist we should all have more either (1) to spend in consumption or (2) to save as capital. It is unlikely that (1) would monopolise the new fund, for even if it tended to do so the increased demand for consumable goods would in itself set up an increased demand for fixed capital to provide them. This net loss of saving capacity through taxation may be called "y." But, of course, all other things would *not* be equal, and the cessation of Government expenditure might so adversely affect the possibilities of effective saving that accumulation of capital wealth would be actually retarded. A potent factor in successful accumulation and maintenance of capital is the setting aside of part of individual funds for collective use. This gain of saving capacity through Government expenditure may be called "x."

Hence we have the compulsory postulate at the

[1] These paragraphs are taken from *E.J.*, 1913 (S.).

outset that capital will be better situated by a certain definite sum being raised in taxation than if it were not raised, the net gain being x-y, a positive quantity. That definite sum having to be raised, the question is:

If part of the sum is raised by Death Duties, will it be less advantageous to capital wealth than if the whole sum were raised by other taxes? Do Death Duties (1) *annihilate accumulated capital, or* (2) *prevent accumulation, and if so, do they do so more than other taxes?*

I propose no inquiry into the value of "x," but deal entirely with "y" to see if non-recourse to Death Duties will put "y" at a minimum, and therefore $(x-y)$, the capital gain, at a maximum. (Here it is necessary to point out that "Capital Gain," $x-y$, is not synonymous with *total national gain*. Even if one concludes that Death Duties adversely affect capital, and more so than other taxes, they may have other effects on national well-being which are fully worth it. Accumulation of savings is not the only important factor in well-being and the nation might easily save too much. I am not concerned with the wider inquiry.)

The first superficial observation when a payment out of an estate is made is that the capital value of that estate is reduced—the difference of capital has "gone." The reply that capital can only be embodied in material goods, and that these all remain the same, nothing having been burnt or destroyed, and that only a change in the title to use has taken place, so that the *National Capital* is unchanged, is

only a little less superficial, and does not meet the point. For, of course—leaving the Government out of the question for the moment—there is at any given time a fund of immediate fluid savings offering itself for embodiment in fixed forms, and it is out of this that the estate duty payment comes. A pays the Government by selling land to B, who buys it by selling shares to C, who has not consumed all his income in the year current but was looking for an investment for the balance. If C had not bought the shares he would have supported a *new* investment, and, let us say, built a house. So even if no existing capital form is annihilated, we can at any rate say that a new capital form has been prevented from coming into being.

But, of course, we cannot ignore the question as to what the Government does with the money. If it builds the house that C could not build, then the net effect on national capital is nil—there is merely a transfer from individual wealth or rights to collective wealth or rights, just as there would be if, wanting a building for offices, the Government took over, as its tax, the ownership of an existing building. But if the Government drops the money into the sea there is a net loss in national capital, and C's potential house is never erected; just as there would be if the Government burnt the building that it had taken over.

In either case, therefore—destroying existing capital, or preventing accumulation of capital—we are concerned with Government action. Hence arises Plehn's warning that to regard death duty as

current revenue and not to treat the yield as a permanent endowment for a specific purpose is an improvident proceeding, "inasmuch as the tax is drawn from accumulated capital and not from current income." It "would seem wise to use the income solely for buildings or improvements of an enduring character." But, of course, the *specific* application is not necessary—if the Government is spending in "permanent improvements" or objects of a capital nature the equivalent of the death duties it is as broad as it is long, and the other sources of revenue, which appear to be coming out of income and not capital, are assignable to non-permanent expenditure. No doubt opinions differ as to what constitutes capital expenditure, down from permanent military or naval works through battleships, to a completed land valuation, or a real but intangible organisation for National Insurance, but the two last mentioned would not appear in any ordinary computation of national capital, and, therefore, may reasonably be held to be no substitute in this connection for the cotton mills that might otherwise have come into being. Gladstone held the view, prompted, I believe, by J. S. Mill, that death duties applied to the reduction of National Debt remained "capital" still. The community are in debt to A, and discharge the debt by buying War Loan with the death duty from B, who sells a house to pay the duty, A buying the house with the proceeds of the War Loan. A is in the same "capital" position as before, B is the loser by a house, and the community are the gainers by the liability discharged.

This accords with the usual treatment of the National Debt in computations of national wealth.[1]

So much for the immediate effect of the transfer of wealth. There is annihilation of existing capital only in rare cases. There may be prevention of immediately potential capital if the Government has no equivalent capital expenditure.

But the last position is not peculiar to Death Duties. By our postulate the money has to be raised. If it is not paid by death duties on the wealthy, assume that it may be obtained as income tax on the middle class. The tax may then prevent them from saving what they were in the habit of doing, they may be pushed out of the new investment field and we may thus get an equivalent prevention of immediately potential capital. Or assume the revenue is obtained from the poor. If it does not come out of potential savings it must lessen consumption expenditure. This may or may not be efficiency-expenditure, but if it is, it reacts on productive capacity not only for the labourer himself, but reduces also the total industry-dividend, the share of the employer, and therefore the saving fund of the wealthy. *There is no proof that the immediate effect of taking revenue as death duty reduces immediately potential fixed capital more than an income tax which may equally trench upon potential savings.*

But the dynamic aspect over a series of years must now be considered in addition to the static position for a single year which is all we have so far treated.

[1] *Vide* "The Wealth and Income of the Chief Powers," *S.J.* 1919 (S.).

Even if transferring wealth from indivuduals to the community does *not* affect the grand total at the moment, or even if there is little difference between transferring the house that a man has already saved (death duties) and the sterling that a number of people might just be going to invest (income tax), the knowledge that saved wealth will some day be transferred may powerfully affect the desire to save.

A completely confiscatory duty would almost stop most types of saving.

At one time it was thought that death duties would " tend to diminish the funds destined for the maintenance of productive labour," but that view is to my mind tainted with the " wages fund " fallacy. Mill considered the amount which would be derived by a high duty would be but a small proportion of the annual increase of capital in a wealthy country like ours, and its abstraction (and annihilation) would but make room for saving to an equivalent amount.[1] I agree with the first part of his view, but the second I think can only be assumed given certain conditions as to the rate of interest. It might be true in times of rising prices and trade activity, but not in times of stagnation. Sidgwick thought that the bad effects are " not likely to be at all equal in proportion to the similar effect that would be produced by extra taxes on income; in fact, the limits of taxation on inheritances will be practically determined rather by the danger of evasion than by the danger of checking industry and thrift."

[1] Mill, *Principles*, V. ii.

Bastable urges the same point, and considers, too, that the "equal amount of taxation would have to be imposed in other directions, and would in some degree trench on capital."

In the case of a mortgage on an estate raised to pay the duty, when the efforts of the owner to redeem it in fifteen years cause him to reduce expenditure, reduce wages and discharge servants, the result does not seem to differ essentially from what might follow an equivalent annual tax for fifteen years.

At the root of the whole matter lies the question: Will a man save less or more per annum if he has to pay a lump sum at death instead of an annual tax?

Now to the extent to which he himself turns the lump sum into an annual tax, by specific insurance provision, there is no difference. If he would have paid the income tax out of potential savings, out of consumption expenditure, or partly out of each, so equally may he be expected to bear the annual equivalent of the death duty. If this is widely done, death duties are not specially disadvantageous in their effect upon accumulating capital in comparison with an income tax.

Bastable regards the estate duty as a capitalised income tax, and many others have held this view. Seligman contests the point, but his objection, in my judgement, only amounts to showing that this cannot be used as a theoretical justification for the duty, because of the divergent rates of income tax that would result from the uncertainty of length of life. It does not alter the argument that if all persons

pool their risks in insurance the tax may in fact be a general community income tax. But we have to recognise that to a considerable extent it is *not* turned into an income tax by the individual, and it is over this field of inquiry that most difficulty arises.

Apart from what the Government may do with the money, and from the individual point of view only, most writers seem to feel that the duty falls on accumulated wealth rather than on income, though admittedly the economic position of society and the habits of the people are important factors.

Professor Cannan has said: "Perhaps, on account of a certain obvious peculiarity of the time at which they occur, death duties discourage accumulation somewhat less than annual taxes, and consequently are rather more favourable to the non-propertied class. If they are graduated they necessarily tend to cause greater equality of wealth."

Now, it may be demonstrable that two burdens are actuarially alike, and yet the psychological appeal to the taxpayer may be very different. The bearing of this possibility upon this subject has not been really finally worked out and agreed, but Professor Pigou has recently treated it with some fulness.[1] He says: "*It has now to be observed that the check on the supply of waiting, brought about by the expectation of death duties, is likely*, ceteris paribus, *to be considerably smaller than that due to the expectation of the former kind.* Let us suppose that a million pounds has to be raised by taxation upon

[1] Pigou, *Wealth and Welfare*, p. 374, etc.

the fruits of industrial investment. It is indifferent to the State whether this annual sum is collected by a tax on the annual returns of all enterprises, or by a tax confined to the annual returns of enterprises that have been established for some time. The choice between the two methods is not, however, indifferent to the persons concerned in the enterprises. Since these persons discount future taxes precisely as they discount all future events, the expectation of taxes levied after the second method will have the smaller restrictive influence upon the quantity of waiting supplied by them. The fact that distance in time introduced a considerable chance that the investor may no longer be living when the postponed tax falls due greatly emphasises this difference. Hence, there is a special and not generally recognised advantage in taxation by the method of a time limit. Delay in the levy enables the State to collect a given annual sum, in such wise that the expectation of the levy exercises a smaller restrictive influence upon the supply of waiting, and, hence, upon the magnitude of the national dividend, than would occur if the levy were immediate.

. . . .

"The argument, however, is not yet exhausted. It has to be observed, further, *that the superiority of postponed over immediate taxes is enhanced when the levy is made, not after a distinctive time, during which there is a chance of the occurrence of the investor's death, but definitely at his death*; for, obviously, a certainty influences conduct more strongly than a probability. Furthermore, there are additional

reasons why this form of postponed tax should impose a relatively small check upon the supply of waiting. In some measure the stimulus to accumulation consists in the hope of the distinction afforded by dying very rich. That stimulus is not interfered with by death duties."

Further points may be added to those put forward by Professor Pigou if we once admit that our income tax differentiates against savings-use in favour of consumption-use. People may be divided into two classes: (1) Those who are ambitious to die as rich as possible; (2) those who are indifferent to the actual sum left at death.

In the case of (1), as Mr. Carnegie has urged,[1] the death duties have no effect on saving. In the case of (2), prospective death duties may militate less against saving than equivalent income taxes, because there is always the *chance* of living to a good age, and being able to avoid death duties by division *inter vivos* at a late, but not too late, period, and a good many people may take this chance of "no tax at all," when no differentiation exists (for them) against savings-use. (But if many actually succeed and realise their hope, then, in order to maintain the total yield, the death duties rates must be *pro tanto* higher than the income tax rates.)

The whole fund of saved capital is a resultant of many different psychological forces, which do not answer in the same way to changes in conditions. The behaviour of those who are saving against risks or against being worse off, those who are saving

[1] Carnegie, *Problems of To-day.*

to be better off, and those who save without effort or self-sacrifice out of superfluity, will be very different. The net effect of all motives together cannot be finally determined. If taxes are paid out of pure economic (unearned) surpluses they have less tendency to shift effects to other factors of production and other social classes than if they are paid out of " earnings " (salary, interest, or profits) which have functional value in inducing full maintenance of the producing agent.

Despite these psychological considerations, however, on the whole, I think there may often be a tendency to curtail expenditure to meet an *annual* income tax, and to keep on saving and thus in the long run add more to capital than would be the case under the death duty regime. The very fact that the total annual yield is made up of a large number of comparatively *small* " doses," and that to each individual the payments are *regular*, must, I think, assist this tendency. In so far as this is true, death duties trench more upon the annual new investment fund and less upon the consumption expenditure than income taxes would do, but not to any marked extent. Of the £26,000,000 raised, a large part would be covered by insurance and have the same annual incidence as an income tax. Of the balance only a small part, probably not more than two millions, would be paid out of savings, where it might under an income tax have come out of consumption expenditure. This in relation to the total annual savings of about £350,000,000 is almost negligible. People greatly exaggerate this matter,

because they forget that the money must be raised somehow; and *from the gross effect of the death duties on capital they fail to take off the effect that other equivalent taxes would also have upon saving.*

(1) As a broad conclusion, therefore, apart from other economic effects of death duties, even current expenditure of the proceeds is likely to add to the nation's power of accumulation more than the actual *capital* it takes from individuals.

(2) *Immediate effect on realised savings.* (*a*) In so far as Government expenditure is in permanent works or reduction of debt there is only a transfer of capital. (*b*) If it is not so spent, savings may be "wasted," but if the money had been raised by other taxes, potential saving might have been "wasted" to just the same extent, and no special disadvantage attaches to death duties.

(3) *Ultimate effect on stimulus to saving.* Owing to powerful countervailing considerations the net effect is only slightly against the death duties as compared with other taxes. Reverting to the idea with which I opened, the death duties may leave "*y*" almost at a minimum. This is only an expression of personal views and no reliable body of received opinion exists. [The analysis of the past decade, with death duties much more widely spread and of increasing severity, supports the view (*a*) that on balance the death duties do not greatly affect business initiative (*vide* Schultz: *Taxation of Inheritance* p. 208) and (*b*) that normally they do not destroy capital. But the popular view persists, that, especially when no sinking fund exists,

they "take capital and spend it as income." This is generally assumed to be bad for the community, but now that it is increasingly recognised that the unco-ordinated action of the individuals comprising the State may sometimes result in "savings exceeding investment" and so creating unemployment, it may even be a good thing that the State should spend capital. The discussion in the Colwyn Committee's report, 1927, contained my own views, but it is too long to be summarised here.]

7. *The Effects of a Capital Levy on Saving*

As a last example of the difficult consideration of "effects" on saving, we may well refer to the capital levy.

While one writer urges that a 7s. 6d. *income tax* on future savings must be a "grave discouragement," another declares that he cannot imagine the temperament on which "a capital levy would not have an economically depressing effect." One well-known publicist says that saving under modern conditions is "one of the highest of civic virtues—ultimately the attack on capital will recoil most disastrously on those who labour with hand or brain. Capital is a shy bird—you cannot *compel* men to energy and responsibility, etc." The opposite view is strongly expressed: "The levy is likely to promote individual abstention from consumption, more than War Bonds do. The head of a household who has to meet a 10 per cent capital levy will be much more disposed to insist on a drastic cut at

current expenses than one who had just invested an exactly similar amount in Bonds and knows that his income, far from being lowered, is actually being increased," etc.

It is clearly a question whether the levy would have a greater deterrent effect upon saving than an income tax producing the same net change in net annual income.

It will be obvious, from a consideration of published opinions, that little real light is thrown upon the probable effect upon the mind of the investor, for they are very opposed and contradictory. The contradiction really arises from the habit (which is inveterate even among economists) of thinking of the whole fund of accumulated savings as though it were homogeneous, whereas it is an aggregation of separate funds saved under entirely different motives and answering quite differently to changes in economic conditions, *i.e.* a change in the rate of interest increases some classes of saving and diminishes others.[1] It is necessary, therefore, even if perilous, to consider the question under the various sections into which the total saved fund of the United Kingdom (amounting to some 350–400 million pounds per annum in pre-war years) may be roughly divided.

Personal Savings against being worse off

(1) "*Long-distance spending.*" When money has to be spent in large lumps at considerable intervals and the immediate income of the time of

[1] Cp. Gonner, *Interest and Saving.*

spending is insufficient for the purposes, the prudent person puts by against the event, and thus equalises the charge. The simplest examples are Goose Clubs, Coal Clubs, and Christmas Clubs, as well as various devices for saving for "holidays." There is no intention of being permanently "better off." Such cases as these can be ignored, but the analogous "saving" by the better classes is important. A professional man with £1000 a year has a young family, and realises that at a certain period some thirteen to eighteen years ahead he will have to find considerable sums to "put them out"—fees for articles, college, and examination courses, etc. Rather than reduce his income very heavily when that time comes he prefers to put aside regularly, and so spread the burden. He could probably do this whether there were interest or not, and though a higher rate makes it slightly easier (and he may, therefore, have to save a little *less*), in general, interest has no important bearing on his resolve, and his mind is fixed rather on the *capital* sum that will be requisite. Assuming for the moment that the net income from which he has to save does not differ greatly under the rival methods of taxation of his earnings (which have not changed since the time before the levy), his saving will not be greatly affected if the income tax on unearned income is high or low. But the apprehension of a further capital levy is important—it may "catch" him in the middle of his programme before the time for spending has arrived. To him this fund is not *capital* at all, it is merely a suspended expenditure

account, and a levy is peculiarly hard upon him. He will be led either—

(1) to save still more than before so that the net sum left after a repetition of the levy will be the sum required ;

(2) to abandon part of his programme, not save at all, and put his sons to less dignified professions ;

or (3) to leave the expenditure to come in a lump when it falls due, and if necessary borrow and pay off out of his *subsequent* earnings.

The first course is very unlikely, and having regard to the peculiar inequity of a levy on "long distance spending," the fear of a levy is likely to be far worse than a high income tax.

(The example is, of course, not exhaustive of this class—it is merely an illustration.)

(2) *Insurance at death.* This is generally a provision for family and dependents in the extreme event, and the capital sum for which a man will insure cannot be greatly affected by the difference in the net rate of interest, except over intervals of time so long that countervailing considerations (such as social habits or the expectancy of life) may affect premiums also. There would, therefore, be no great effect upon savings through a change in income tax (except that a low tax on current earnings would give a larger income out of which to save), but if the present exemption in favour of savings by way of life insurance premiums is continued, the effect of a high rate of tax would be to force savings out of other categories into that differ-

entially favoured form. On the other hand, the apprehension of a levy (which would apply to the value of the accumulated premiums) destroys any such differential advantage. But suppose that the life insurance allowance *ceases*, and there can be a straight comparison between a high income tax and a capital levy. Then the choice is between (1) a high income tax on the income before it is saved, plus a high income tax on the yield of the savings (which is hidden and never really felt or noticed by the insurer), and (2) a low income tax in both respects, plus a prospect of a substantial curtailment of the *capital provision.* Provision of this kind is in so many cases an absolute necessity (the insurer feeling that he must on no account leave his family badly provided for) that, as between giving up insurance wholly or in part and the more heroic course of insuring for a *larger* gross sum, in order that the net sum may remain as originally intended, the average man will choose the latter alternative. In so far as this is so, a larger sum will be saved under the levy scheme than under the income tax. Stated in economic terms the "demand for a standard provision at death is very inelastic."

(3) *Endowment insurance.* In so far as this is a mere variant of the foregoing insurance plus a provision for an income in old age, after 60 or 65, the capital sum is the main consideration, and the demand will be inelastic, so that the levy method will tend to increase the amount that is saved. But in so far as it is an *alternative form of investment* —the income tax allowance being assumed to be

withdrawn—people think more of the total capital that is coming to them than the hidden net income which accumulates to make it up, and the apprehension of a levy is a more real thing than the unseen differences of income tax. The tendency in this section will be for a levy to diminish the savings under this head. As the *investment* section of endowments for the wealthier classes is probably greater than the life insurance provision, the balance for the whole class is rather against the levy.

(4) *Savings to be better off.* Ordinary investments in property, shares, etc., by the individual exercising a definite choice between spending and saving, as a class represent mainly saving for an improved immediate *income.*

The very low net yield of investments under a very high income tax must have a grave effect on this class of saving. It is not unlikely that with many people a low income tax, giving a large income out of which to save, and a larger margin of returns on the investment, will be preferred ; and that the fear of a repetition of the levy will hardly outweigh such definite advantages. It is impossible to judge with any exactness, and on the whole it is probable there will be no great difference in this section in the effects of the two methods.

(5) *Savings out of superfluity.* The type of rich people like Carnegie, who find it easier to let their superfluous income pile up than to think out ways of spending it, is not unimportant. The great point is that saving is automatic and does not

depend on a nice balance of future advantages, or the exercise of any individual will at all. Here the low income tax would yield a wider margin of surplus to be saved, and the "fear" of the levy is not a determining factor. Moreover, if the individual is running a business which offers possibilities of expansion, the pure love of power and scope will cause the absorption of the surplus moneys without regard to the future. Here the levy method would have no worse effects, and, if anything, slightly better, than its rivals.

(6) *Impersonal or collective saving.* A very substantial contribution to the total accumulated savings is made by companies, etc., reserving sums out of profits. These reserves (*a*) bear a normal rate of income tax only, and (*b*) are only remotely affected by a levy—*i.e.* in their influence on the market value of shares. But the important point is that the personal question whether to spend or to save, and the temptations of riotous living, are hardly present at all. The directors, often only slightly concerned in their personal holdings, find it quite easy to declare safe dividends of moderate amount and to put the whole of the balance by, especially as the main feature in their minds is the expansion of business for which they see the clear opportunities. On the whole, this class of saving will be hardly deterred at all by the mere fear of a levy, and it will be much encouraged by the low rate of income tax which we still assume is in force, so that there will be a net advantage under the levy scheme.

On forming a kind of tentative mental balance-sheet of the different classes, bearing these proportions in mind, one may conclude that, upon the whole, on something of the order of 35 per cent of the savings there would be balance in favour of the levy, not quite counterbalanced by the disadvantage on a smaller section, with a large part indeterminate. These proportions, which are, of course, open to challenge in every way, only illustrate the kind of quantitative determination that one's mind would strive after if the data were available. The most that can be said is that the extreme statements made on both sides of the controversy as to the effect on the total savings are probably both wrong, and that the *total* net effects would not be greatly different under the two methods. In proportion as the fear of repetition is less, the advantage of the levy method will become more apparent in this particular respect. One must beware of making the social psychology more actuarial than it really is. As Romanes said: "Reason is very far indeed from being the sole guide of judgement that it is usually taken to be—so far, indeed, that, save in matters approaching downright demonstration (where, of course, there is no room for any other ingredient), it is usually hampered by custom, prejudice, dislike, etc., to a degree that would astonish the most sober philosopher could he lay bare to himself all the mental processes whereby the complex act of assent or dissent is eventually determined."[1]

[1] *Thoughts on Religion*, p. 136.

But a very important reservation has now to be made. It has been assumed throughout the above that the *status quo* in the matter of distribution of wealth has not been profoundly modified by taxation by way of a levy. For if by the levy the rich have been made poorer and the poor richer, the aggregate power to save (or to balance the spending-use against the savings-use successfully in favour of the former) is diminished. Mr. W. H. Mallock has dealt pertinently with the point,[1] and though the figures given may not be absolutely accurate they illustrate the argument :—According to the Census of Production (1907) " income goods " to the value of 300 million pounds are converted into new capital annually. This saving of income, or this diversion of productive power from the production of consumable goods into agencies for producing more goods, is, as matters stand, equivalent to a voluntary tax on total income. At present, three-fourths of these savings (which in all are about £15 per head of the occupied population) come from the richer classes (about £170 per head) and the rest from the poor classes (about £4 per head). But in proportion as incomes were equalised, these savings or this voluntary tax would have to be equalised also. If *all the income* from capital were divided among the workers equally, it would mean for each a bonus of about £15 in addition to his total income. But if all were credited with an equal share of capital all would have to save equally, unless the total saved capital is to diminish. The individual savings must

[1] Mallock, *Capital, War, and Wages.*

rise from the present £4 by an additional £11 to £15. The net addition, therefore, to the individual's spendable income would be £4 only. This extreme instance shows how unlikely it is that £y will be saved out of a total income of £x, if £x is divided among many instead of a few.

The conclusion here, therefore, is that in proportion to the magnitude of the debt redeemed, and to the steepness of the graduation, the saving power of the community as a whole is diminished by a levy forthwith, and that even if the lower taxation produced subsequently on account of the levy method gives a slight balance of advantage in the incentive to saving out of the future incomes as so redistributed, that balance is hardly likely to outweigh the damage done to total saving power by the redistribution itself. The net result of the fear of a further levy in the first few years following the imposition of the first may be a slight diminution in the total saving of the country.

8. *Effects on Prices*

As an example of a case where a tax might even serve to cheapen goods, we may take the operation of the American tax on business profits. It will be remembered that the standard was not less than 7 and not more than 9 per cent on capital, or 8 per cent if there were no pre-war profits. The tax on the excess was progressive, viz. 20 per cent on the excess profit up to 15 per cent; 25 per cent on the excess from 15 to 20 per cent; 35 on the excess from

20 to 25 per cent; 45 on the excess from 25 to 33 per cent, and 60 per cent on the excess profits over 33 per cent. In the case, therefore, of a business making 35 per cent, the true net rate would be 24·8 per cent on the whole profit, reducing it to a distributable yield of 26·3 in the following way:

Capital £10,000.		Profits £3500.	
Tax on first, say	£900	*Nil.*	
,, ,, next	600	15%	= £90
	500	25%	= £125
	500	35%	= £175
	800	45%	= £360
	200	60%	= £120
Tax on	£3500		£870
	or 24·8%		

The yield would be reduced from 35 per cent to 26·30.

It will be seen, therefore, that on this method of taxing by "slices" the final rate of the scale must be very high before the average rate is at all heavy. For example, the true rate on a 20 per cent profit is 10·75 per cent only, reducing the profit to 17·85 per cent on capital. A 15 per cent dividend would be 14·1, allowing for the tax. If the rate of profit was 100 per cent, the tax would reduce it to 52·3 per cent.

It is difficult to see how this gradual entry into taxation can constitute at any ordinary point a severe deterrent to personal enterprise beyond that point.

Now assume a monopoly revenue of £50,000 upon £100,000 capital (or 50 per cent). It may be that

the monopoly revenue on the larger supply from a capital of £130,000 would be £52,000 (or 40 per cent), and the extra £2000 profit resulting from the larger supply from the extra capital of £30,000, being only $6\frac{2}{3}$ per cent, is not considered worth while. If the graduated tax reduces a 50 per cent yield to 35 per cent, the monopolist would be left with £35,000 made on £100,000, but it might reduce a yield of 40 per cent only down to $33\frac{1}{3}$ per cent and leave him with £43,333 in the second case, instead of £52,000. In this case the employment of £30,000 more capital may yield £8333 more net profit, or nearly 28 per cent, and so be well worth while. The monopolist will be induced to supply a larger quantity of goods at a much lower price, because the differences in the total yield of capital are so much reduced in taxation, and the relative yield of marginal capital so much increased.[1]

9. *Effects of Import Duties*

Import Duties are such a well-worn topic that I need not devote much time to them. In a discussion of broad principles I may shift the responsibility of discussion of a political matter by quoting from the leading tariff writer of the chief tariff country: "They are commonly shifted to the consumer and are meant to be so shifted. In the controversy about protection, zealous advocates of high duties are led occasionally to maintain that taxes on imports are borne not by the domestic consumer, but

[1] These paragraphs are taken from *E.J.*, Dec. 1919 (S.).

by the foreign producer. This may sometimes be the case, just as it is sometimes the case that an internal tax is borne for a longer or shorter period by the producer, and not the consumer. Occasionally, where the producer (domestic or foreign) has a monopoly, he may bear a part of the tax—conceivably may bear the largest part of it. Sometimes he seems to bear it though he does not do so in fact. He sells the commodity at the same nominal price, but with shorter measure or poorer quality. Most often of all, the same unconcealed and simple result ensues, both from internal taxes and customs duties—the commodity rises in price by the full amount of the tax."

It is best, of course, frankly to admit all this on economic grounds, and then to say that we want the duties for ulterior objects—*i.e.* for their further dynamic effects in inducing a domestic supply. As to whether the nation as a whole gets a good bargain at the price paid is, of course, the whole issue involved in protection, and has a different answer for each time and place.

As Professor Taussig points out, supervision for customs duties can be limited to the ports,—a few leading spots, and no elaborate organisation is required over a wide area. Hence, a thinly peopled developing country finds these duties a most *convenient* form of raising revenue. The "incidental effects on the course of domestic industry are at first overlooked, and then when they have established themselves are welcomed." Moreover, their removal means a grave disturb-

ance to established or vested interests. Taussig says that apart from duty on sugar and the objectionable and regressive duty on wool, the tariff in the States has fallen mostly on finer goods, and the enhanced prices have been a tax on the better classes. His conclusion is: "The main objection against our regime of higher protection was not so much that it caused disproportionate burdens on those least able to pay as that it gave a disadvantageous direction to the productive energies of the community." [1]

You often hear it levelled against a proposed protective duty, that either it will keep things out and therefore bring in no revenue, or it will bring in revenue and fail to protect—a kind of fatal dilemma. But it has always struck me as a particularly inept sort of jibe. For it assumes that one can have only one object (either revenue or protection) and not a major and a minor object. As the man said when there were two ladies in a dark lobby and he did not kiss the one he had intended to, "even failure has its compensations." And most of us would agree that failure was not easily to be distinguished from success!

[1] Taussig, *Principles*, vol. ii., chapter on Taxation.

CHAPTER VI

THE STANDPOINT OF THE COMMUNITY: ULTERIOR OBJECTS

1. *Ulterior Objects allowable if Secondary*

We have all heard that it is wrong to marry for money, but quite praiseworthy to marry where money happens to be. So taxation for other than revenue objects, to punish or to discourage, taken by itself might sometimes be indefensible. It should be called what it is, a fine or penalty, and not a tax. To this class one might perhaps assign the claim of the person who hates cats, and who would therefore put a tax on them in a sort of spite, regardless of the possible revenue, cost of collection, hardship to individuals, and a mouse millennium.

If, however, in the course of deciding how to raise a revenue, the State can so place its burdens as not to discourage things that are worthy, and not to encourage things that have hurtful tendencies in the State, plain common sense is its justification. But the extent to which a government should be swayed by revenue considerations only, as against ulterior aims, is always a nice question of degree, and the actual and avowed attempt to achieve

special economic development by taxation is in some senses a modern manifestation.

"Taxation for revenue only" was a Victorian slogan the echoes of which we still hear. If a tax modified or set out to modify economic conditions it was suspect at once; but the public attitude of mind towards the principle has considerably changed of late years.

As Professor Marshall says, "equity was considered an adequate guide to the philosophy of taxation."[1] This "equity" had regard, of course, to existing conditions, and was on the basis of existing rights. So that, if existing conditions or existing rights were not all that could be desired, the taxation scheme is under suspicion of being wrongly based, and even of aiding and abetting abuses. Professor Marshall says that "while a joint stock company is obliged to accept existing rights as final, the State is rather under an obligation to go behind them, to inquire which of them are based on convention or accident rather than fundamental moral principle, and to use its powers for promoting such economic and social adjustments as will make for the well-being of the people at large."[2] In his view the problem of taxation is one of constructive ethics, calling on its technical side for careful economic and political thought.

2. *Redistribution of Wealth*

The first problem is that of the distribution of

[1] *After-War Problems*, p. 317. [2] *Ibid.*

wealth, and, starting with the right of the State to improve it by way of taxation, one can, without recourse to ability to pay, or to the principles of equal sacrifice, or to economic surplus, reach progressive taxation.

As I showed in my second lecture, Marshall's doctrine of least aggregate sacrifice as distinct from equal sacrifice leads more easily and quickly to pure confiscation of the higher reaches of income than equal sacrifice can do. Indeed, with the assumption of the duty of the State to rectify inequality of fortune, it is difficult to stop short of this position: that if we have to raise 500 millions for State expenditure we should lop off the top 500 millions of individuals' incomes, by which I mean that we keep paring away at the excess of the income of the richest above their next richest neighbours until we have the amount we want. This means in actual practice that all incomes would be cut down to £2000 and less, and that a £500 or £1000 income would pay nothing. Such action does not reach a socialistic redistribution, for that, of course, would continue the "taking-away" process, beyond the needs of State expenses, to hand the amount to the poorest classes, and would cease to be taxation, rightly defined.

Dr. Marshall says that, "while special provision is made for those whose incomes fall short of the necessaries of life and vigour, every one else must bear a considerable share of the national burdens, but the shares must be graduated *very steeply*." [1]

[1] *Ibid.* p. 319.

This cannot be achieved by commodity taxation, but only by a very large use of taxes on income and property.

Suppose that, having cut down all incomes to say £2000, the State requires another 100 millions. Acting on the same principle, the incomes from £1500 to £2000 would then be entrenched upon, by way of a further attack on the old victims, and a new attack on the original £1500 to £2000 class. But the £1400 man would still pay nothing. If we concede the full logic of the State's obligation to use its powers for improving distribution, as the first principle of laying out taxation, I do not think we can stop short of this, but it clearly does violence to the first principle of relative "ability," and its economic consequences to the dynamic life of the community would be disastrous. So personally I adhere to the view that first one must assume the differences in wealth and ability to have some ethical or economic warrant behind them, and tax on equitable grounds on that assumption; provided, secondly, that the burden so laid has no economic reactions inimical to the progress of society, one can then examine the basic assumption, and if it is felt that it is not fully sound, and that some people are richer and others poorer than can be justified either on ethical or economic grounds, one can go cautiously away from the first results by judicious modifications. For example, suppose we think of the community as consisting of a doctor with £500 a year, and another with £15,000, and the principle of equal marginal

sacrifice leads to the view that we can take £20 from one and £7000 from the other, we do this without any implication as to their relative worth, skill, or industry. Judged by external tests, the difference in remuneration is fully warranted, and we have no hesitation about that side of it, but settle our taxation by differences of ability on the *spending* side. Now suppose the class worth £500 never saves anything, and the class worth £15,000 if untaxed saves £6000, and we have to face the fact that if accumulation of capital has any value in social and national progress, our line of taxation has cut off our only fund for securing that advantage. We may have to modify our first taxing proposal for the national good, even in the ultimate interest of the £500 class. Or again, suppose the cutting down of £15,000 to £8000 makes the great doctor disinclined to use his powers or exert special abilities, the nation may ultimately be much poorer than if it taxes all the £500 people even say £40 each, which is again higher than would be justified on the first principle alone.

This is an inexact and very homely attempt to indicate that the principles of relative "ability" and maximum national advantage may not give coincident results. Now, when we introduce the third principle—the obligation of the State to rectify unjustifiable differences of wealth—we put it upon the State to inquire into the merits of the two incomes and to ask such questions as the following: Is it really possible for pure ability to be worth so much more than ordinary powers can command? Is not the reward too high? Does not this man

exploit the monopoly of his name and fame, and draw as unearned wealth fees from a lot of old ladies who fancy they have something the matter with them? Unless we are going to deny that men differ in ability, in application, and in thrift, and that those differences are rightly reflected by some difference of fortune, we cannot carry the obligation of the State to rectify inequalities of fortune beyond that part of the inequality which we can confidently assert is not a proper reflection of the inequality of ability, application, and thrift.

It is for these reasons that I feel the doctrine adopted by some modern writers that progressive taxation finds its true theoretical justification or basis in the obligation of the State to rectify inequalities in distribution, is partly illogical and considerably over-emphasised. In my judgement it does no more than lend support to the progressive principle, and if given pre-eminence is misleading and dangerous.

Professor Taussig thinks that " ability " justifies proportional taxation only, and that progressive taxation finds its justification in amending the existing social order. He says: " The question of equity in taxation cannot be discussed independently of the equity of the whole existing social order. The courageous advocates of progression base their views precisely on the ground that the existing social order is not perfect, and that taxation should be one of the instruments for amending it." [1]

But Taussig admits that " equality of sacrifice "

[1] Taussig, *Principles*, vol. ii., chapter on Taxation.

if applied unflinchingly leads to high progression, and he thinks this is to admit that the working of individualism is not to one's liking. Taussig also asserts that the discrimination between income from effort and income from investment can only properly find a basis in a similar discontent, whereas I have endeavoured to show that in the difference between the two such classes of income there is no such implication—they are equally worthy and useful, but one entails greater compulsory spending obligations, and leaves a net residuum of pure taxable capacity less than the other, with equal gross amounts. So on neither count do I accept Taussig's results when he says: "Any conclusion then in favour of progressive taxation and of the higher taxation of funded incomes must rest, to be consistent, on a frank admission of unwelcome features in existing society and on a programme of social reform." But fortunately when he comes to application of the principle he says: "Progressive taxation, so far as it aims to correct unjustified inequalities, evidently deals with results, not causes. It is obviously better to go to the root of the matter, and to deal with the causes. Much the more effective and promising way of reform is to promote the mitigation of inequality in other ways,—by equalisation of opportunity through widespread facilities for rational education, by the control of monopoly industries, by the removal of the conditions which make possible illegitimate profits. Progressive taxation, which deals with income (or property) solely according to size, and not according to social

desert, is less discriminating and also less effective in reaching the ultimate goal than the various ways of spreading material welfare."[1]

He urges all the points which I have put forward to show that the theoretical engine of justice which he has constructed will not work at all properly in practice, and so he leaves the actual progressive taxation of income without any reasoned basis. If progression as we see it does not accord exactly with the principle of securing social justice as he sees it, then I think it indicates that we must declare it to rest on the other principles to which I have referred, which could still stand secure even if every inequality of fortune were a true and proper reflection of inequalities in effort, ability, and thrift, and these differences were themselves recognised as justifiable. In the latter case apparently Taussig would find no justification for progression at all.

In my judgement, progressive taxation has the happy results of assisting to rectify inequalities, many of which are not economically or ethically justifiable, but it does not *exist* to do this, and it has its justification quite apart from this.

3. *The Doctrine of Established Rights*

It has been stated that the old ideas of taxation for revenue only were based upon a political philosophy of established rights.

Adam Smith is supposed to have thought only of the individual and the State in a fixed relationship

[1] Taussig, *Principles*, vol. ii., chapter on Taxation.

to each other, and never to have dreamt that the State could use its powers of taxation to further in a dynamic sense a progressive society. We are told that just as the State can modify the static world and the relationship between itself and its constituents, by national insurance, pensions, etc., so it can remedy abuses and promote changes by its taxation policy, and this is entirely a modern conception. While I do not deny the general character of eighteenth-century political philosophy, I think it is demonstrable that Adam Smith was not shackled in the manner suggested. In one place he refers to the hurtful nature of fines on renewal of leases, very much as modern writers might do, and suggests that the practice might be discouraged by heavier taxation.[1]

In another place, when he is discussing the arbitrary conditions that were often laid down for cultivation of the soil, and their restrictive effects, he suggested a higher rating to discourage the practice.[2] Similarly he wanted to discourage rents in service. Then, to give an example of positive policy, he was prepared to see special abatements in taxation to encourage owners to cultivate their own lands.[3] These instances hardly indicate that Adam Smith was hide-bound in a policy of "taxation for revenue only." Such a maxim would, of course, readily emerge from the nineteenth-century policy of *laissez faire* carried to extreme lengths, and from a Spencerian political philosophy. But as our political ideas have undergone modifications, and we have begun to think of dynamic motives (or ulterior

[1] *Wealth of Nations*, vol. ii. 2 (1). [2] *Ibid.* [3] *Ibid.*

objects as I have called them), enthusiastic heralds of the new thought have gone to extremes and have certainly taken their doctrine too seriously. I have shown that it is claimed that the social dynamic is the true and only basis of progressive taxation. I deny this, but admit that in its rectification of inequalities when they are unjust it is a useful concomitant. But some inequalities are quite just, and like the rain the rectification falls on the just and unjust alike.

4. *Earned and Unearned Incomes*

In a like way it is claimed that discrimination between earned and unearned income is a part of this dynamic policy, for it has been said that taxation of unearned income at a higher rate is "aimed at altering things." "It gives up the simple ideal of equal sacrifice on the basis of existing incomes, and substitutes for it the dynamic idea of reducing certain incomes which come to their possessors in certain ways."[1] This is tainted with the idea of differences in economic or moral worth, or in ethical deserts, and is plain rubbish for any one who will read the report of the Committee of 1906 which recommended the change, or the long literature of discussion which led up to it. The discrimination was based upon plain extensions of the principle of pure ability, as I endeavoured to show in the third lecture. In so far as there are a number of people "gathering where they have not strawed,"

[1] Taussig, *op. cit.*

living idle lives, or "battening on society," the discrimination has the fortunate result of burdening them more than the workers. But it is rather indiscriminating in its discrimination, for it burdens equally the interest going to the worthy hard saver, and to the mere unworthy inheritor—again upon the just and unjust alike.

All this *ex post facto* special pleading is really very much like claptrap. Surely there are at least as many unworthy earned incomes as unworthy unearned incomes, and how discrimination can be regarded as an engine of social justice, beyond plain justice within the confines of taxation, is a mystery to me.

5. *Taxation of Alcohol for Non-Revenue Reasons*

The same kind of confusion of causes is shown by the new thought over the taxation of the liquor trade. Alcohol is found to be at the root of very grave social evil, and it is said that for that reason it is taxed. Whatever might be our wish in this matter, starting *de novo*, this can hardly be said to be historically correct. For in the past the licence payments have been, on the benefit principle, equivalents to the State in return for monopoly rights, and taxes on the product date certainly from times when drink was not in any way regarded as an injury to society. We now have certainly a new justification for these particular taxes or for increasing them, which perhaps I may express in three ways :

1. It is not unreasonable to make a particular traffic which is very costly to society in its indirect effects, contribute something specially towards those costs.

2. Taxes on alcoholic liquors are one of the few effective ways of reaching the economic surplus element in the wages of the poorer classes, *i.e.* that part of their income which *de facto* has little or no effect in maintaining their efficiency, and forms no part of the true subsistence wage ; and

3. Indulgence in alcoholic liquor is with many an evil, and the State may well discourage or punish its use by special taxation. Here again you will see the new doctrine of the State right to a dynamic policy is only subsidiary and the taxation can be justified without it. Once again, too, the rain falls on the just and the unjust alike, for the policy is carried out with no discrimination—the tenth pint of the drunkard pays the same tax as his first, and the same tax as the occasional pint of a most abstemious man. If one could not justify taxation of alcoholic liquors on general economic grounds, but had to rely on the new-found principle, it would find but poor justification in its actual working out in practice. Again I regard the dynamic or ulterior objects as useful and excellent adjuncts to good pre-existent justifications for this type of taxation.

6. *Special Taxation of Land*

The special taxation of land is one of the most conspicuous examples of the new policy. So far

as this country is concerned we may begin with the Agricultural Rates Act, which represented an attempt to ameliorate the conditions of agriculture by giving a differential relief at a time of great depression, and which was, therefore, a very negative example of policy. The land taxes of 1909–10 were the Increment Value Duty, the Reversion Duty, the Undeveloped Land Duty, and the Mineral Rights Duty. Economic justification is found for the increment duty in most countries where it has been attempted, on the benefit or betterment principle, that is the resumption by the community of part of the value socially created or created by communal expenditure. But, as I have said already, it has been justified in this country particularly upon the windfall or "special ability" principle, the principle that a receipt of money like an increment in site value has a peculiar faculty for bearing taxation with less psychological sacrifice than a corresponding receipt of ordinary income. In abstract theory, such taxation should have no special dynamic tendencies—the increment will be there whether it is to be taxed or not, and the tax cannot be shifted. I have indicated that the reversion duty might be said to have an economic justification as making good a technical omission in the income tax, and the undeveloped land duty may be thought also to fill up a gap which is left by leaving the representation of ability solely to the test of annual *cash* incomes. But, of course, ulterior objects figured most prominently in the active campaign for these duties. It is true that a fine

revenue was expected, and that the need of tapping new sources was emphasised, but most people will agree that breaking up the land monopoly, discouraging the leasehold system, promoting the release of developing sites and therefore the expansion of building activity, to say nothing of the general discomfiture of dukedoms, were the great arguments for the policy. It was frankly taxation with ulterior objects—"God gave the land to the people," in many variants and every key. As the most open and avowed example of the new doctrine of dynamic taxing policy, these duties have been peculiarly unfortunate—much more so, in fact, than in theory they really deserve, and I shall not attempt to assess the reasons here. Our advocates of rating reform in the special taxation of site values, or the exemption of buildings, frankly hold out the improvement of our economic organisation as the goal, and do not base their programme upon "benefit," or upon "equality of sacrifice." Of course, the whole family of the single taxers claim an economic taxing justification in the peculiar character of economic rent, but it is the economic *result* that is put forward, rather than the merit of following a correct theory. An enthusiastic commissioner at Houston, Texas, thus extolled the system he had introduced a couple of years before:

"Under the Houston plan of taxation vacant lots which have heretofore been used as a receptacle for old tin cans and rubbish, are now being improved and put to their best use. The longer the system remains in operation the greater will be the benefit

to the majority of the people. The only man who can complain is the man who is holding much vacant land out of use, refusing to improve it, and refusing to sell it at what it is worth for use to some one else. When the Houston plan of taxation is carried to its logical conclusion, people will begin to realise what the millennium upon earth means."[1]

Another modern single taxer says: "The purpose of the single tax is much more than a mere fiscal reform in the method of raising public revenues. When fully applied, it will abolish land speculation and involuntary unemployment. Full application of the single tax will give to land users all the profit and product of their labour in using the land, and will necessarily make it impossible for any person to gain a profit by merely owning land without himself using it. This will not reduce or interfere with the rent or income an owner may get for the use of land improvements."[2]

But the strongest reasons for the single tax are moral rather than fiscal. "Ground rent is the surest and safest method yet invented by which one person gets the product of another's labour, and gives nothing in return. This is a moral wrong."[3]

The general verdict seems to be that the exemption of building improvements greatly stimulates building, and that was the experience in Australia and New Zealand. But the taxation of land on its building value instead of its actual yield had given rise to the very irregular and patchy development of

[1] *Readjustments*, p. 194 (J. J. Pastoriza).
[2] *Readjustments*, p. 223 (W. S. Wren). [3] *Ibid.* p. 225.

the outskirts of American cities as compared with a more regular and steady extension of towns here. Owners of outlying sites which are beginning to get a future building value, rather than pay heavy taxes out of agricultural rents, precipitate the development in order to get some kind of rent out of which to pay the tax. Obviously the weaker owners succumb first, and the building takes place in a spasmodic and not very sightly fashion. In so far as the holding up of central and fully eligible sites is discouraged, of course, undeveloped land taxes are quite useful stimulants and beneficial to the community.

7. *Ulterior Aims in other Taxes*

One might spend time in going over numerous small taxes in different countries that have been imposed to meet definite evils rather than for fiscal reasons. The negative policy of repression is much more common than a positive policy of encouraging worthy objects.

We still have some survivors of the immense variety of taxes that existed during the eighteenth century and the Napoleonic wars. Many of those taxes were attempts at taxation according to the principle of ability, and represented the best approach to an income tax that could be made by an accumulation of presumptions. Amongst them I may mention the odious hearth tax, the window tax and its successor the house duty, taxes on carriages, silver plate, men servants, female servants, horses,

racing, sporting, hair powder, armorial bearings. But the taxes on dogs were imposed with very little fiscal design and almost entirely for reasons of policy. Public feeling was so outraged by the dog nuisance that Pitt was glad to remedy it by a tax, which he attempted to frame in such a manner as to be graduated according to ability.[1] In 1853 Gladstone abolished the distinction and imposed a higher rate. The evasions were most common, not more than a quarter of the dogs being charged. A new scare and a hydrophobia panic renewed the efforts at repression, and in 1867 Childers reduced the rate and made a serious and successful attempt to remedy the evil. No one could for a moment regard the dog tax as an "ability tax," and it stands even now as primarily a non-fiscal imposition. The gun licence was imposed in 1870 in response to an agitation against the too free use of firearms that then prevailed.

There were many taxes imposed without reference to personal ability, but purely for fiscal reasons in times of great stress, such as taxes on auctions, probate duties and stamp duties, and in an altered form several survived.

Professor Marshall has suggested that present fiscal needs justify some minor or "ability" taxes being imposed, such as a steeper and higher inhabited house duty, and a tax on domestic servants. A tax which would have little bearing upon personal ability but which might be imposed for fiscal reasons, and also to some extent for other minor objects,

[1] Dowell, iii. p. 266.

payable 1 per cent monthly, but for each child born, 25 per cent of the loan is given up altogether and a postponement of the payments allowed. The intention here was to increase new employment of girls, and also the sale of furniture.

Rebates of 10 per cent in income tax are allowed in respect of money applied for new buildings at certain dates, while certain house property is freed from income and property taxes for a period of years. The sales tax on agricultural produce was reduced in order to enable the proceeds to be applied to improvements and so give additional employment, and there were many other special features with the same object. Thus, even arrears of taxes were cancelled if the money was being spent on property repairs, and a 10 per cent rebate off the income tax was given specifically for this purpose. The taxation of partnerships was reduced and that of companies increased in order to bring about a stimulus to personal responsibility. In connection with the rebates for personal taxes, a fiancé is legally a member of the family. In the case of the sales tax, it was deemed to be against the principles of national socialism to let it fall on the weaker retailers; there is a stiff differential tax on capitalists who have "amalgamated" since 1931, and even in the indirect taxation for tobacco the rates are so arranged that the smaller manufacturers are relieved and encouraged. Altogether, the programme is an elaborate machine for ulterior social ends, with little or no regard to actual revenue objects.

There is a proposal in Holland for a tax upon

subjects travelling abroad, progressive with the duration of absence. This is obviously designed to keep people from spending money abroad, and thus has two ulterior objects—however ill founded—the first the maintenance of home trade, and the second the maintenance of revenue from other objects of spending. So taxes may be imposed to protect other taxes !]

9. *Taxation of Imports*

The taxation of imports for objects other than simple revenue is, of course, the most important section of the subject of "ulterior objects," both because it is oldest and also because it has been so widespread. As I have already said, customs duties have often been imposed because they have been administratively the easiest way for a particular country to get revenue, and then they have been continued by reason of their secondary effects, when the revenue could have been dispensed with or obtained in other ways. Moreover, there are no taxes so difficult to remove, by reason of the vested interests in trade which they set up and which naturally object to any policy of "fast and loose." When looking for motives for continuing protective duties we must not forget such a case as that of the United States, where constitutional difficulties in connection with encroaching upon the taxing rights of the several States have, until recent years, almost deprived the federal government of the opportunity for raising a substantial revenue outside the customs. But even so, it is not improbable

that the States would have had practically a free trade history if it had not been for the Civil War, with the revenue tendencies it started, and the interests it set up.

The *ulterior objects* of customs duties may, it seems to me, be classified as follows :

1. To protect and benefit particular industries which have been able to secure State action frankly in their own interests.
2. To protect and benefit particular industries as part of a national policy of benefiting all, either by giving a definite direction to the economic development of a country or as a considered means of keeping its activities diversified and well balanced, and preventing too great a degree of specialisation.
3. To benefit the nation from the point of view of defence in event of war, by ensuring home supplies of food or essential articles.
4. To prevent dumping.
5. To be used for retaliatory and bargaining purposes against the tariffs of other countries.
6. To promote trade in particular economic directions and further a unity already existent from the point of view of political government and sentiment.
7. To give a start to an industry which once established will have such natural advantages as to be self-supporting (the infant industry plea).

Now it will be obvious that in a small part of a single lecture I cannot hope to give an illustrative

treatment of all branches of tariff policy, so I shall content myself with summarising my own conclusions under each head, without extended reasons.

The first class, that of the protection of industries for sectional advantage, can be illustrated in the tariff history of many countries, and this limited policy has met with many successes. The particular industries protected have been prosperous, and made profits beyond those which would have accrued to them without the tariff. Generally speaking, the wider the tariff the less the industries working behind it have been able to secure advantages which would not have equally accrued without a tariff. No reference is made under this head as to the greater aggregate prosperity of the country.

There are also illustrations of industries which would have been better without protection—those which depend more on self-reliance and ingenuity for their success—where the high prices resulting from inefficient business have kept the total volume of business down to meagre limits.

Dr. Marshall recently said with great justice: "Unfortunately the experience of many centuries shows that a policy, which will confer a considerable benefit on each of a compact group of traders or producers, will often be made to appear to be in the interest of the nation; because the hurt wrought by it, though very much greater in the aggregate than the gain resulting from it, is so widely diffused that no set of people are moved to devote much time and energy to making a special study of it. Its advocates speak with zeal and the authority of

expert knowledge. But they are bad guides, even if unselfish and perfectly upright; for a policy that makes for their peculiar profit is invested in their eyes with a deceptive glamour."[1]

Under the second head, the protection of particular industries not for the sake of the persons engaged therein, but as a part of a considered general policy for the national benefit, *bona fide* illustrations are far fewer. Obviously, it is most difficult to say whether the policy is successful as a whole, for it is always open upon the one hand to allege that an acknowledged progress is due to the tariff policy, and on the other to urge that that progress was due to different causes, and would have taken place, or even have been greater, if the tariff had not existed, and we have the great world causes of gold production, population movements, and political upheavals to complicate the problem. Moreover, we have to define "*progress*," and to ask whether too much attention may not be paid, relatively, to the statistics of foreign trade: whether a hectic prosperity may not be secured by the too rapid exhaustion of natural resources; whether a greater national income badly distributed is a boon; whether a high degree of specialisation and the sacrifice of the elements of a full life are better than a more varied existence with less "material" prosperity; whether "opulence" has been of greater importance than "defence." When we have settled what we mean by progress, we may begin our investigation of individual cases. In my judgement,

[1] *After-War Problems*, p. 330.

there is no single instance in which it can be demonstrated beyond the cavil of individual prepossession or inclination, under one or other of these heads, that a tariff has contributed a net advantage or disadvantage to a nation as a whole by the protection of specific industries, apart from those dealt with under particular heads hereafter. Germany probably did more in the direction of thinking of the country as a whole than any other nation, and, even there, other ulterior objects besides national development upon a particular line were present.

Dietzel was a sound critic, and he said that the recent failure of German policy must be a lesson to England.[1] From 1879 to 1891 the tariff was protective, then Caprivi added retaliation by a double tariff. His inducements succeeded because (1) there was a *clear end* in view to increase exports by increasing agrarian imports ; (2) he started from a known fixed basis ; (3) the conjuncture was favourable—an alleviating policy when others were aggressive and startling the industrial world. A number soon made treaties, and Russia was quickly brought down from an obstinate position.

The 1902 policy had *no* conquests, for Italy and Belgium were easy in any case. It had no settled aim—it tried to satisfy the agrarian and industrial claims at once. It had no fixed basis, and the conjuncture (of irritable nations) made war favourable, for Germany applied the method of "preparing for war," and this was a contagious spirit. Negotiations had to be based on new, uncertain tariffs.

[1] Dietzel, *Retaliatory Duties*.

Putting up tariffs *for bluff*, with bargaining intentions, had let loose wholesale protectionist cupidities, riveting in their consequences, and pretence became reality. Caprivi's refusal to adopt this method was justified by facts. "We have driven the agrarians into the arms of the manufacturers." "We made it impossible for foreigners to guess how far we were serious." "Had we adopted persuasion, foreign agrarians and merchants would have been the allies of our export manufacturers and would have resisted the protectionist tendencies of their own manufacturers." "Our agrarians welcome the 1902 tariff and do not mind its failure retaliatively." The Bülow policy failed where the Caprivi policy would have succeeded.

Germany, of course, generally tried to get a revenue as well as to develop along national scientific commercial and political lines, but in the former she was not very successful. In particular the revenue from manufactures was small. Dr. Marshall has well pointed out: In 1913, Germany reaped about 2s. per head of her population from taxes on finished goods of all kinds (*fertige Waren*): and it is probable that the population of Britain will need to contribute about a hundred times as much as this per head to her Exchequer after the war.[1] Germany's taxes on manufactures were but small percentages on the values of the quantities taxed, which were themselves not nearly co-extensive with the quantities imported, since for one reason or another the sharp edge of nearly every tax on manu-

[1] *After-War Problems*, p. 335.

factures had had to be blunted; but there was no mercy for the "food of the people." Her import duties on grain, even after allowing for large rebates and bounties on exportation, yielded far more than all those on finished and half-finished goods. Some advocates of protection for British manufactures will learn with surprise that her receipts from import duties on "raw materials for the purposes of industry" ("Rohstoffe für Industriezwecke") yielded almost the same amount as those on finished goods.[1] Naumann, in *Central Europe*, said that even the recent agricultural protection had not secured a progress more rapid than the previous policy, nor better than Switzerland, Belgium, Holland, and Denmark.

The third class of objects may be summed up in Adam Smith's well-known words, "Defence is greater than opulence." Germany again may be taken as the example both for objects of defence and offence, in a scientifically directed policy to secure adequate food supplies and the existence of big or key industries. I think that the most ardent free trader will admit, after our recent experiences, that we may well pay a price during peace, via protection, for an insurance against various dangers in time of war, and that it may be a real economy to do so. The question whether any differential gains in the form of economic rent so created must necessarily remain wholly in private hands need not be pursued here. Sir T. Middleton and others have shown that from the point of view of the human

[1] *Ibid.*

effort required in this country to get a given yield in agriculture we were not unfavourably placed and could more than stand comparison in efficiency with Germany.[1]

I need not labour the key industry question, and I think that if a matter is so vital to a State as to be protected on this ground, its risks and profits should not be left entirely to private persons even behind a tariff wall, but that the State should take its share of the capital involved, so that the taxpayer may, in the event of profits, participate in them, as against any burden he may assume as consumer.

The fourth object, the prevention of dumping, is distinct and local and is clearly a fair aim if dumping is properly defined and distinguished from clear competition on stable and sustained lines.

The fifth object, retaliation, is at the bottom of the modern developments of tariffs, general, conventional, minimum and maximum, and all their complications. On the broad aspects, it may be said that the usual allegations of protection of national honour are not justified as the sole reasons, for, generally, there is no element of national insult, and, after all, sectional advantages are being striven for. Further reprisals usually follow. History gives us a few surprising examples of success from the Flanders duty on English woollen goods in 1697, which induced England to give up lace duties, down to modern times, but there is also

[1] *E.J.*, 1917, p. 143; Middleton, *Recent Development of German Agriculture.*

much clear failure and waste of national effort. As Dietzel says, the most effective method is usually rather costly and involves real sacrifice, but if success does not come early it is not likely to come at all.[1] Retaliatory duties have been often the slippery slope to unvarnished and haphazard protection. Certainly in theory, both retaliation and reciprocity if applied at the right time, and to the right things, with a very wise and sensitive judgement, may further free trade or national advantages, and the extent to which this can eventuate in practice depends upon the strength and reliability of our political institutions as organs of economic policy.

The *sixth ulterior object* is best illustrated by our own scheme of Dominion preference. There is no other really good illustration within my knowledge.

The *seventh object*—the protection of infant industries—is the one case of protection which is held to be theoretically justified by practically all parties, but by no means all agree that the same result cannot as well be obtained by other methods, such as direct subsidies. The whole matter is more conspicuous for the thoroughness with which it has been worked out in theory in the text-books than the extent to which it has been illustrated either by them or in real tariff history.

Professor Taussig says that probably the 1857 duties in the United States, which on their face were protective, did not in any important degree have the effect of stimulating industries that could not have

[1] Dietzel, *Retaliatory Duties.*

maintained themselves under freedom of trade—the extent to which mechanical branches of production have been brought into existence by the protective system has been greatly exaggerated by its advocates, and even the character and direction of development have been influenced less than, on grounds of general reasoning, might have been expected.[1]

10. *Discriminations in Taxation*

If the State wishes for national reasons to benefit or assist certain trades, I think, in general, the worst method is by discriminations or differentiation in taxation. Direct subvention is open, known, subject to constant check and control, and its cost is spread over the nation. Indirect benefit is hidden, unknown in amount, subject to little control as to efficiency, etc., and the cost of what is assumed to be a *national* benefit is paid by that section of the community which happens to use the products in question. During the war there was an epidemic of attempts on the part of most worthy and essential traders to get regarded as the very pivot of the war, and to have special treatment by way of relief from a general tax which was admittedly burdensome. I became convinced that taxation must be a business apart, and cannot be mixed up with the weighing of claims to financial assistance, with the conditions of assistance, and the necessity for expert consideration of the possibilities of each case. No taxation department

[1] Taussig, *Tariff History of the United States*.

ought to be mixed up with that side of national policy.

Governments are usually anxious to assure the industrial community that their taxation measures will not adversely affect saving and capital accumulation. Sometimes they are asked to use taxation exemption or differentiation for the purpose of positively encouraging saving. A strong plea was made to the Colwyn Committee to give specially lenient treatment to undistributed profits kept in businesses for their extension; but whatever the economic advantages of this might have been it failed through its practical difficulties to receive the Committee's support. No one, however, raised a doubt that the non-distribution of profits or accumulation of capital was not a worthy object. Contrast the opposite policy recently embarked upon by the United States Treasury, where they have proposed heavy progressive taxation of undistributed profits. Although they have disclaimed the motive of "reform", it is not possible to escape the conclusion that much of the advocacy is not on behalf of revenue as such, but really a conviction that the accumulation of undistributed profits in reserves is not a good thing and ought to be discouraged. An official spokesman before the Senate Committee gave some glimpse of the mind of the Government when he said that there was ground for suspecting that the accumulation of these very corporate surpluses assisted materially the course of the depression. There is no doubt a strongly held view in the United States that the excessive

saving from 1923 to 1929 by corporations and individuals was an important cause of the subsequent collapse. This illustration shows how easily taxation policy may be influenced not only by settled or accepted ulterior motives, but by those very motives themselves influenced by unsettled or disputed economic theory resting on temporary considerations.]

11. *Taxation of War Fortunes and Excess Profits*

The proposed war fortunes tax, apart from its fiscal results, will, it is claimed, have the merit of allaying social unrest, and the sense of injustice which rankles with many that at a time of general suffering and privation certain individuals should be advantageously placed. It is urged that the heroic expedient of the capital levy would have like results, and it would serve to enable the currency to be deflated and to reduce prices generally. Neither of these imposts would, of course, do very much as a prevention against future profiteering, whereas the Business Profits tax on American lines, taxing profits progressively as they get more and more excessive and more "profiteering" in character, can be urged to be a real dynamic force, and a kind of economic brake. Moreover, if it is urged that on the imposition of a tariff certain individuals receive an unwarrantable benefit, such persons would come automatically under the provisions of a duty which thus becomes of double importance.

12. *Conclusion*

I am hopeful that my attempt to sketch out the main principles of taxation emerging from the world experiences of to-day from three distinct points of view may have proved of assistance to some of you, even if you are not personally engaged in the fine art of "plucking the goose with as little squealing as possible." I have not pointed the way to a perfect tax, for in M'Culloch's adaptation of Pope:

> "Whoever hopes a faultless tax to see,
> Hopes what ne'er was, or is, or e'er shall be."

Let the Chancellor have your sympathy, your personal assistance, and if need be your conscience money. There is nothing romantic about increasing your burden of taxation, and the poet reserves all his enthusiasm for the Lady Godiva, who loved the people well, loathed to see them overtaxed, and accordingly—at what must be conceded to have been some personal inconvenience—

> "took the tax away,
> And built herself an everlasting name."

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THE END

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